Setting the global standard for investment professionals

July 30, 2010

Sir David Tweedie
Chair
International Accounting Standards Board
30 Cannon Street
London, United Kingdom EC4M 6XH

International Accounting Standards Board Discussion Paper, *Extractive Activities*

Dear Sir David,

The CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the International Accounting Standards Board (IASB or the Board) Discussion Paper, *Extractive Activities* (the DP or Discussion Paper).

CFA Institute represents the views of its investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

Summary of Comments

We believe that fair value is the most relevant measurement basis for financial statement information. In the context of the extractive industry we recognize that the preparation and audit of such information is not without challenges; however, we believe that the information content of fair value measurements is of far greater relevance than the measurement basis proposed in the Discussion Paper. We elaborate on this point in our response to Question 6 which follows.

[1] With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

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We have two general concerns about the Discussion Paper as follows:

- We do not think the Discussion Paper fulfills the due process requirements of the IASB; and
- It is our opinion that many of the proposals in the Discussion Paper are based upon a questionable cost-benefit analysis and assumptions or reasoning which could be more fully refined.

We elaborate on both of these points in the next section of this letter, followed by responses to the questions posed in the Discussion Paper.

Our concerns with the Discussion Paper itself are as follows:

1. The Discussion Paper does not sufficiently explore the range of possibilities regarding how financial reporting for companies in extractive industries could change in order to provide the most decision-useful information to the financial markets. Said differently, the Discussion Paper does not provide a comprehensive overview of the financial reporting issues for companies in extractive industries and it does not examine all the possible approaches to addressing such issues. As expressed in the IASB's *Due Process Handbook* (Paragraph 31), which is excerpted below, a Discussion Paper should include:

   > *[A] comprehensive overview of the issue, possible approaches in addressing the issue, the preliminary views of its authors or the IASB, and an invitation to comment. This approach may differ if another accounting standard-setter develops the research paper.*

2. The Discussion Paper states (Paragraph 1.20) that:

   > *"A general purpose financial report is directed toward the common financial information needs of a wide variety of users."*

   The DP goes on to state that the needs of "sophisticated" financial statement users may differ from those of other users. It then posits that the views of 34 sophisticated financial statement users interviewed as part of the development of the DP are representative of the views of all financial statements users.

   We find that this line of reasoning could be refined because:

   i. The DP does not define "sophisticated." We think any effort to make such a distinction among users of the financial statements would not be fruitful.
   ii. The DP survey sample is small and heavily weighted to sell-side analysts. The information needs of sell-side analysts versus those of institutional investors and investment advisors may be very different as institutional investors and investment advisors make mostly analytical judgments and valuation decisions. Additionally, industry specialists may also have different information needs from those of portfolio managers and other users who research more than one industry. Overall, the DP would have benefited from consultation with a range of analysts.
   iii. Financial markets rely on relevant financial information. While financial analysts and others play an important role in the process by which financial statements are incorporated into market prices, the process is complex and poorly understood.

What we believe is clear is that financial reporting that contains market-relevant data improves the efficient allocation of capital.

3. The DP proposes a measurement basis, historical cost, that the DP project team ultimately concedes has limited utility for investment decision-making. It reaches its conclusion by relying on its small sample of "sophisticated" users and on a supposed "cost-benefit" analysis. This "cost-benefit analysis" is then used to justify the Discussion Paper proposals.

4. The "cost-benefit analysis" analysis accepts, without significant objective evidence, the assertions of preparers that the preparation of fair value information would be cost prohibitive. Our experience suggests that such estimates can be overstated. We think it is unfortunate that the DP does not consider a more balanced argument that incorporates the significant costs that financial statement users incur because they do not have access to decision-useful information. In markets, the shares of all companies, regardless of industry, trade at market prices that are a proxy for fair value. If investors begin with financial statement presented on a historical cost basis, investors must undertake the responsibility of translating those historical cost measures into market values and are exposed to exponential amounts of estimation error relative to management which have access to much more granular, non-public information that can be used to assign much better estimates of market value.

5. The object of financial reporting is to represent faithfully the financial position and operating results of an entity, not to provide information in the footnotes that some users may be able to use to calculate values for themselves. While we recognize, conceptually, that the footnotes are an integral part of the financial statements, our experience has been that footnote information may not be as rigorously prepared and audited – and hence not as useful – as data contained within the basic financial statements. As such, we believe the information as important as the fair value measurement of extractive assets be included within the basic financial statements rather than in the footnotes. We do not believe providing fair value information, or underlying data upon which fair value may be computed, within the notes is most useful as we do not believe disclosure is a substitute for appropriate recognition and measurement principles.

6. The Discussion Paper states (Paragraph 1.3) that:

   'There is also no direct relationship between the risks and rewards of a particular exploration program. For example, a very small expenditure may result in a major find while substantially larger expenditures may result in nothing being found."

   The DP goes on to endorse historical cost accounting – and in the context of the quote above the recognition of costs without the recognition of the underlying fair value of the assets being extracted – despite the fact that it does not faithfully represent the financial position or operating results of companies in the extractive industry. The US Securities and Exchange Commission (SEC) concluded in the late 1970s/early 1980s that neither the "successful efforts" method nor the "full cost" method provides financial markets with decision-useful information. The failure of the SEC, and the FASB, to follow-up on its plan to propose a better accounting method does not preclude the IASB from doing so.

7. The DP does not make reference to any empirical research on the market relevance of financial data for the extractive industry. For example, Boone (2002)[3] demonstrated that the standardized present value measure required by US GAAP Topic 932 (formerly SFAS 69) exhibited significantly more explanatory power than the historical cost measure.

8. The Discussion Paper aggregates exploration, development and production extractive assets when from an industry, economic and decision-usefulness point of view these assets are quite different, and consequently the analysis of each would be expected to be quite different.

9. The DP notes that assets must be tested against current value[4] for impairment. We would observe that the DP is concerned with how management discretion and subjectivity would affect the preparation of fair value measures but that current value will be utilized for impairment. While we believe that fair value is the appropriate measure for extractive assets we also believe that it must be applied continuously not just based upon artificial impairment triggers which may be applied inconsistently. Analysts want to evaluate the reliability of such fair value measures over time and impairment triggered fair value measures do not enable analysts to effectively evaluate the reliability of such management estimates over time. Over time, analysts can determine whether management effectively incorporates new information into its estimates and assumptions and can evaluate the usefulness and reliability of management's estimates of fair value.

10. We believe that a discussion paper should be an open minded exploration of the stated financial reporting issues rather than justification for existing guidance. As our concerns above suggest, we do not believe this Discussion Paper explores these alternatives nor arrives at the most useful conclusion for investors.

[3] Boone, Jeff P., *Revising the Reportedly Weak Value Relevance of Oil and Gas Asset Present Values: The Roles of Measurement Error, Model Misspecification and Time-Period Idiosyncrasy*, The Accounting Review (January 2002), pp. 73-106.

[4] The Discussion Paper utilizes the term "current value" and provides, in general terms, its definition. The DP also explains that fair value is one type of current value measure. We would observe that fair value does not yet have a standardized definition under IFRS and that when issuing a final standard on extractives industries, a fair value definition will likely have been included within the IFRS literature. Our stated preference is for fair value as defined in FASB Topic 820 (formerly SFAS 157) and as being exposed, and defined, as an exit value notion in the IASB's Fair Value Measurement Exposure Draft. In the context of an extractive industries' exposure draft, we believe it is important that measurements be consistently defined and applied to ensure user understanding. As such, we believe that a final standard that includes both "current value" and "fair value" may result in a lack of consistency and comparability.

<u>Responses to Discussion Paper Questions</u>

Question 1 – Scope of Extractive Activities
In Chapter 1 the project team proposes the scope of an extractive activities IFRS and indicates it 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 support the scope of the Discussion Paper.

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 support the approach of the Discussion Paper.

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?

Resource definitions and their application are very technical, often reflecting local conditions. The definitions proposed in the DP are not consistent with those used in countries such as Canada and the United States. Geologists, regulators, preparers and financial statement users are familiar with these systems used in Canada and the United States. The proposed standard should work with well developed practices in those countries as well as other countries around the world.

The IASB Discussion Paper does not provide information on the potential effects of implementing the proposed revised definitions in practice. More study on such changes may be needed. Only summary information on their purported merits is provided. We think the argument in support of common resource definitions has not been adequately made.

Convergence to a global standard should not be an objective in and of itself, but a means to provide users with better information. The IASB staff should reconsider the necessity, benefit and costs of having a single global definition when geology is regional.

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 recognized 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 recognized and when should they be recognized initially?

We agree that the Conceptual Framework definition of an asset, establishes a "legal right to use" as a prerequisite for an asset to be recognized.

We do not support the approach that all subsequent exploration activities are an enhancement to the asset. Often exploration expenses do not provide any tangible or intangible benefit. In statistical terms the value of a null result (no resources here) is very small because the expected value for a very large number of samples is also a null. Exploration cost should only be capitalized if a positive result in found. The assessment that the value of exploration expenses is often zero is currently reflected in industry practice of writing-off certain types of exploration costs.

We do not support the approach of grouping different phases of extractive activities (exploration, development, production, etc.) as proposed in Paragraph 3.7. We agree with Paragraph 3.4 that there is widespread acceptance of the different phases within the industry. Both industry and financial statement users view property that is in different phases as being distinct. The activities, people and financial information needed is different for each phase. For example, an exploration geology (exploration phase) is not the same profession as a mine geology (production phase). Exploration phase companies can normally only obtain equity financing and then only at a very large discount to the potential value of the extractive asset. Alternatively, a producing gold mine can often raise funds based on proven and probable reserves through a gold loan with terms and conditions very similar to a loan on inventory.

The early phase of exploration work is analogous to research and development, whereas the production phase consists of industrial activities. Current IFRS uses different models for these activities. We believe that boundaries between phases should be established in IFRS and we would prefer distinct accounting methodologies for each. The purpose of financial reporting is to provide decision-useful information to users in making asset allocation decisions. The information required when considering an investment in an exploration company differs from the information required when considering an investment in a producing company.

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?

It is unclear if the component approach of IAS 16, *Property, Plant and Equipment,* would result in an appropriate unit of account when applied to assets in the extractive industry.

Our view is that extractive assets should be accounted for differently if they are in the exploration phases (research and development), development phase (construction) or production phase (see response to Question 4).

We do not believe that geography should be the only criteria for establishing the unit of account – that is geology and other factors should also be considered. In many cases, assets within the same geographic region should be accounted for separately. For example, combining oil sands and conventional oil located within a particular province of Canada would not provide decision-useful information for investors. Deep water offshore oil and onshore oil in Louisiana is another example of assets that should be accounted for separately.

Question 6 – Minerals or Oil and Gas Asset Measurement Model
Chapter 4 identifies current value (of which fair value is one type) 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.

The CFA Institute has long expressed its membership's preference for fair value as the means for measuring assets and liabilities. Our fundamental support for recognition and measurement principles based on fair value reflects our view that fair value measurements reflect the most current and complete estimation of the value of assets and liabilities, including the amounts, timing, and uncertainty of the future cash flows attributable to such assets and liabilities. Fair values are the premise of all asset and liability exchanges, and as such should be represented in the financial statements. One oil company would not buy another for aggregate exploration costs. Rather, the acquiring oil company would acquire and record the assets acquired at their fair value.

With fair value as the measurement method, there is no need for the determination of amortized cost or impairment as would be required by this proposed Discussion Paper.

We agree with the Discussion Paper conclusion that historical cost information is not decision-useful (Paragraph 1.23). Given the consensus on this point, we cannot understand why the DP concludes that historical cost measurement should be used as the basis for recognition in the financial statements. Our question is: how can decision-irrelevant historical cost information satisfy any cost benefit criteria?

Fair value data or proxies for fair value are used by investors in making investment decisions for production and later stage development extractive assets. In addition to numerous other classes of transactions, recent shale oil transactions suggest that fair value is also used for pre-production assets. Fair values are used because they are far more market-relevant than historical cost information. While the usefulness of standardised present value information presented in financial statements is currently limited by insufficient disclosure of key assumptions and concerns with reliability and comparability, the appropriate response is to overcome those deficiencies rather than to revert to a measurement standard that has almost no information value. Standardised measure is widely used by investors because it has proven to be indicative of transaction values, but fair value is the most relevant measure and should be utilized despite the claims of those who declare it too difficult or costly.

We are concerned that the DP bases its conclusion on a small sample of financial statement users. It appears that most of the analysts surveyed are sell-side analysts specializing in extractive industries. We think that the Discussion Paper would have benefited from the inclusion of views from a range of analysts with differing backgrounds. We do not believe that accounting standards should be written only for a narrow segment of the user community. It appears that those surveyed believe that they could use supplementary data and their specialized knowledge to estimate fair value, giving them a competitive advantage. This may be true, but we question whether it is appropriate for a financial reporting standard to provide useful financial information to only a small select group of users. We believe the issue is whether investors more broadly would find fair value information decision-useful without having to have the specialized expertise to translate such supplementary data to fair value like measures. Further, we believe that it is more efficient for companies to estimate fair values and provide such estimates to all shareholders and potential investors.

As stated in the DP, management and preparers must compute, use and have audited their fair values when applying acquisition accounting – a common occurrence in the extractive industry. Investors must rely on these fair value assessments when business combinations occur. As it is clearly relevant to the decision-making process when a business combination occurs, it is relevant to investors continuously as they make investing decisions. The task force apparently made no enquiry about the methods employed when applying fair value in business combinations or whether such methods could be used more generally in the preparation of financial statements.

We also disagree with the view that the inclusion of current or fair value measurements would slow the issuance of financial statements. Accounting and audit processes start well before the reporting period end, especially for large and complex corporations, and estimation is a part of the production of most of these financial statements. Processes and procedures to estimate fair value measurements can be developed and substantially completed in advance of period ends with assumptions updated for significant movements in such assumptions at period ends. This is a routine occurrence in the production of complex estimates in financial institutions, for example.

In summary, we are very disappointed that the DP seems to accept all of the arguments against fair value rather than exploring whether the financial statements of extractive industry participants could be made more informative and relevant to investors by establishing fair value as the measurement basis for extractive assets.

Question 7 – Testing Exploration Properties for Impairment
Chapter 4 also considers various alternatives for testing exploration properties for impairment. The project team's view is that exploration properties should not be tested for impairment in accordance with IAS 36, *Impairment of Assets*. Instead, the project team recommends that an exploration property should be written down to its recoverable amount in those cases where management has enough information to make this determination. Because this information is not likely to be available for most exploration properties while exploration and evaluation activities are continuing, the project team recommends that, for those exploration properties, management should:

(a) write down an exploration property only when, in its judgment, there is a high likelihood that the carrying amount will not be recoverable in full; and
(b) apply a separate set of indicators to assess whether its exploration properties can continue to be recognized 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 proposed approach. The proposal will not result in impairment testing being applied in a consistent manner nor do we expect it to produce timely information. Even with the use of "indicators," management from different companies is unlikely to reach comparable results.

Because the proposal does not differentiate between types of extractive properties, the reliance on management assessment to impair some assets will reduce the informational value for all recognized extractive assets (assuming that there was any value to recording extractive assets at historical cost in the first place).

Question 8 – Disclosure Objectives
In Chapter 5 the project team proposes that the disclosure objectives for extractive activities are to enable users of financial reports to evaluate:

(a) the value attributable to an entity's minerals or oil and gas properties;
(b) the contribution of those assets to current period financial performance; and
(c) the nature and extent of risks and uncertainties associated with those assets.

Do you agree with those objectives for disclosure? If not, what should be the disclosure objectives for an IFRS for extractive activities and why?

We think the disclosure objectives cited above are necessary, but could be expanded to include an additional objective which would require disclosure regarding the comparability of information and transparency regarding the assumptions made between periods (i.e. year-over-year comparison) and among entities.

Question 9 – Types of Disclosure That Would Meet the Disclosure Objectives
Also in Chapter 5, the project team proposes that the types of information that should be disclosed include:

(a) quantities of proved reserves and proved plus probable reserves, with the disclosure of reserve quantities presented separately by commodity and by material geographical areas;
(b) the main assumptions used in estimating reserves quantities and a sensitivity analysis;
(c) a reconciliation of changes in the estimate of reserves quantities from year to year;
(d) a current value measurement that corresponds to reserves quantities disclosed with a reconciliation of changes in the current value measurement from year to year;
(e) separate identification of production revenues by commodity; and
(f) separate identification of the exploration, development and production cash flows for the current period and as a time series over a defined period (such as five years).

Would disclosure of this information be relevant and sufficient for users? Are there any other types of information that should be disclosed? Should this information be required to be disclosed as part of a complete set of financial statements?

The types of disclosure presented above should include quantities as well as value for each commodity. Any changes in reported value and quantities must be reconciled to both changes in assumptions and/or changes in facts. The effect of changes must not be netted. All material changes must be explained. Tabular format is preferable, with notes used to provide further background on numbers presented in each table. An example of reconciliation is included as **Appendix 1.**

Assuming historical cost is incorporated into the final standard as is currently proposed, financial statement users would need all the information necessary to calculate fair value. And, if such information is provided, it needs to be in the level of detail necessary for users to evaluate its quality, reliability and usefulness. Although this information is generally available internally the amount of information required to calculate such fair values is more than what the IASB project team is currently proposing.

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 organizations. 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.

The proposed disclosures presented in Figure 6.1 might be useful to investors but we believe further study as to their predictive capacity for valuation and investment decision-making must be demonstrated, and the cost-benefit of deriving such disclosures should be compared to such predictive ability before they should be required.

Comment and Conclusion from the CFA Institute Extractive Industries Sub-Committee

Approximately, ten years ago the predecessor committee to the CDPC convened a sub-committee of a twelve analysts and users specialized in the oil and gas and mining industries. Similar to the user input to this Discussion Paper, the sub-committee members rejected historical cost information as it was not decision-useful for analysis of extractive assets.

The sub-committee was also concerned that fair value usefulness was limited because of concerns with comparability and reliability. The sub-committee members stated that most would want to be able to modify the fair value for differing assumptions. However, they noted that the difficulty in modifying such standardized SEC type disclosures significantly reduced their usefulness.

The sub-committee members did not necessarily want to calculate fair value themselves and believe strongly that the best fair value estimates would be calculated by the preparers' specialized staff – if the issue of moral hazard and comparability could be addressed.

The sub-committee was then tasked with developing a solution for the long-standing quandary of how to replace historical cost with a relevant and reliable alternative. The sub-committee concluded that proper disclosure, specifically the roll-forward table (reconciliation) attached as **Appendix A** would address both the comparability and highlight moral hazard concerns.

Provided similar disclosure was required, the sub-committee strongly supported reporting fair value over historical cost for measurement of extractive assets in the financial statements.

Closing Remarks

Standard setters in various regions of the world have long-recognized that historical cost accounting is not appropriate for extractive assets. The industry does not use historical cost for valuation of either exploration or production assets. Further, other industries use fair value to account for commodity inventory or similar assets. IAS 41, *Agriculture,* which requires biological assets be measured at fair value is a good example.

Financial statements should contain information that is decision-useful for making capital allocation decisions. Fair value is the most relevant information for investment decision-making as it relates to extractive assets and should be the approach adopted for the recognition and measurement of extractive assets by the IASB for IFRS.

If you, other members of the IASB or your staff have questions or seek further elaboration of our views, please contact either Robert Morgan by phone at +1.514.583.2394, or by e-mail at morgan@forbes-morgan.ca, or Sandra J. Peters by phone at +1.212.754.8350, or by e-mail at sandra.peters@cfainstitute.org.

Sincerely,

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