CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

July 29, 2010

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Subject: **Extractive Activities Discussion Paper**

Dear Sir or Madam:

The Canadian Securities Administrators Chief Accountants' Committee appreciates the opportunity to comment on the Extractive Activities Discussion Paper (DP). The Canadian Securities Administrators (CSA) is an organization of Canada's provincial and territorial securities regulators whose objective is to improve, coordinate and harmonize regulation of the Canadian capital markets. The CSA Chief Accountants' Committee (CAC) is comprised of the Chief Accountants from the provinces of Ontario, Quebec, Alberta and British Columbia. The CSA currently has approximately 569 oil and gas reporting issuers and approximately 1,646 reporting issuers in the mineral extraction industry. As many of these issuers are listed on the junior market in Canada, we are particularly mindful of the costs and benefits for smaller issuers relating to a possible new standard for extractive activities.

Members of the CAC share views on many of the issues raised in the DP. Our shared views are set out in the body of this letter. On the issues of asset definition and impairment, the CAC did not develop a consensus view. Two different views on these issues are set out in the attached appendices.

Question 1 – Scope of extractive activities

We agree with the proposed scope of an extractive activities IFRS.

Question 2 – Approach

We agree that there should be one accounting and disclosure model for extractive activities in both the minerals and the oil and gas industries.

Question 3 – Definitions of mineral and oil and gas reserves and resources

We support the proposed definitions for mineral reserves and resources.

We are concerned that the DP recommends the use of PRMS as the sole standard for the definitions of oil and gas reserves and resources. Consideration should be given to allowing other standards, and in particular the Canadian Oil & Gas Evaluation Handbook

(COGEH). This would be similar to the proposed use of CRIRSCO for mining, which refers to more than one technical standard (such as JORC and SAMREC).

While COGEH and PRMS use the same classification system, the associated guidelines for COGEH are more extensive and have been used and extensively tested. For example, the Alberta Securities Commission (ASC) has completed technical reviews of 1,106 reserves reports which consist of evaluations by 68 evaluators of oil and gas properties in 50 countries. The flexibility that was intentionally built into PRMS leads to less consistent classification than COGEH and makes it less suitable for financial reporting. For example:

- PRMS either allows the inclusion or exclusion of fuel gas in reserves; COGEH does not permit the inclusion of fuel gas.
- In contrast with PRMS, COGEH is explicit in linking deterministic and probabilistic estimates, and also has a specific target for reported proved reserves. This feature of COGEH results in less variance in reported estimates of reserves.

The United Nation's Group of Experts on Resource Classification recently published a report titled "Stakeholder Requirements for Specifications for the United Nations Framework Classification for Fossil Energy and Mineral Reserves and Resources 2009"[1]. The report states that use of PRMS "can lead to limited comparability unless all the associated assumptions are documented and made available alongside the corresponding estimates. Where comparability is required, and particularly where estimates have been aggregated, this requires a higher level of specification in order that there is sufficient comparability. Examples include corporate reporting for financial purposes and government reporting used for international studies." This report also states "Where comparability between estimates is particularly important, e.g. for financial reporting, this requires a higher level of specification (i.e. less flexibility) in order to ensure that the estimates reflect a common basis." In addition, although the US Securities Exchange Commission referred to PRMS in its recent update of oil and gas disclosure legislation, and recognizes COGEH as an appropriate standard, neither the SEC nor the CSA recognize PRMS as an appropriate reporting standard.

We recommend that the classification system selected for use in an accounting standard be one that is appropriate for both financial reporting and other purposes of a classification system. We feel that it is important to avoid conflict or undue variance with the needs and practices of other groups. We do not believe that PRMS is suitable for a wide range of users. We recommend that the IASB consult with a broader group of organisations and individuals in determining appropriate definitions of oil and gas reserves and resources.

Question 4 – Minerals or oil and gas asset recognition model – recognition

We strongly recommend further guidance on accounting for option agreements, service contracts, production sharing agreements and farm-out agreements. We also suggest

[1] http://unece.org/energy/se/unfc_2009_spcfc.html.

providing further guidance on what constitutes legal rights. For example, in some countries an entity may not be able to enforce its legal rights.

Question 5 – Minerals or oil and gas asset recognition model – unit of account selection

We agree that the geographical boundary of the asset should generally form the basis of the unit of account.

We agree that the guidance indicated in paragraph 3.67 of the DP is useful in determining whether items of property plant and equipment are separate assets or part of the necessary costs incurred in order to develop the underlying mineral or petroleum deposit and access the future benefits of the resource.

Question 6 – Minerals or oil and gas asset measurement model

We agree with measurement at historical cost. We agree with the concerns identified by users and preparers about current value estimates of properties as discussed in Chapter 4 of the DP.

Question 8 – Disclosure Objectives and
Question 9 – Types of Disclosure that would meet the disclosure objective

We acknowledge that stakeholders require extensive disclosures on reserve quantities (Disclosure Type 1 from Table 5.1 of the DP) in order to make economic decisions. However, we do not support mandating this disclosure in the financial statements. If a future IFRS requires disclosure of reserve quantities, we recommend an approach similar to IAS 41 such that issuers may disclose the information elsewhere in information published with the financial statements. Securities regulation in Canada already requires companies to provide extensive disclosure about reserve quantities outside of the financial statements. We would be concerned if a future accounting standard required duplicative or inconsistent disclosure in the financial statements.

As discussed in paragraphs 5.21 and 5.22 of the DP, a requirement to audit financial statement disclosure of reserve quantities may be very costly, there may be a lack of appropriately qualified people at financial statement audit firms to perform such audits and the time required to perform audits may adversely affect the provision of timely financial reports. Therefore, we agree with the conclusion set out in paragraph 5.23 that disclosure of audited reserve information in financial statements would not meet a cost-benefit test and may be impractical.

Table 5.1 and paragraphs 5.68 to 5.71 of the DP refer to a reconciliation of changes in reserve quantities. We are unclear as to what is included in paragraph 5.70(b)(i) of the DP. We recommend that technical revisions (as discussed in COGEH), as opposed to price and economic factors, be separately disclosed as part of the reconciliation as this provides a reliable measure of evaluation quality and is important information for users.

In Canada, disclosure of any technical revisions of oil and gas reserves is required outside of the financial statements and this disclosure has been used in a statistical analysis of the quality of evaluation of reserves with the results periodically published by the ASC. This analysis supports the value of separate disclosure of technical revisions. Large technical revisions may raise questions concerning the credibility of the reserve estimation process.

Until recently, the focus of oil and gas disclosures has been on reserves. However, other categories, in particular contingent resources, are becoming much more significant. Therefore, if a future IFRS requires disclosure of reserve quantities, we recommend the IASB consider a requirement to disclose contingent oil and gas resources, if these resources are significant to the entity.

In Canada, a significant amount of activity in the extractive industries occurs through joint ventures, joint operations and joint assets. The DP indicates that the project team's view is that an entity should disclose the minerals or oil and gas reserve quantities it controls which would include reserve quantities attributable to the parent entity, its subsidiaries and its interests in joint arrangements that are not accounted for using the equity method. The current accounting policy choice in IFRS to equity account or proportionately consolidate an interest in a joint venture would mean that there would not be consistent disclosures for reserves that have the same relationship to the entity (i.e. that of being jointly controlled). This could result in an entity not disclosing information concerning significant reserves that it can access. In Canada, some entities conduct all or substantially all of their activities through joint ventures or joint operations. If a future IFRS requires disclosure of reserve quantities, we recommend the disclosures include jointly controlled reserves regardless of what accounting policy choice for joint ventures is made.

We do not agree with providing a current value measurement (Disclosure Type 2A in Table 5.1 of the DP). The option of providing a range of estimates of fair value (Option A in the DP) would place an unacceptable burden on companies in the extractive industries. Consistent with our response to question 6, we agree with users' and preparers' concerns about management's fair value estimates of properties. In addition, a standardised measure of proved and probable reserves (Option B) should not be required as part of an IFRS. Standardized measures have limited value and could be misunderstood in the context of financial statements.

We appreciate the opportunity to provide comments on the DP. If you have any questions on our letter, please do not hesitate to contact us.

Yours truly,

The CSA Chief Accountants' Committee

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Appendix A
Alberta Securities Commission and British Columbia Securities Commission Comments

Of the CSA's approximately 569 oil and gas reporting issuers, 31% are principally regulated by the British Columbia Securities Commission and 57% by the Alberta Securities Commission. Of the CSA's approximately 1,646 reporting issuers in the mineral extraction industry, 62% are principally regulated by the British Columbia Securities Commission and 6% by the Alberta Securities Commission.

Question 4 – Minerals or oil and gas asset recognition model – recognition

We agree with the conclusion set out in paragraph 3.33 of the DP "that rights and information associated with minerals or oil and gas properties satisfy the asset recognition criteria". We agree that E&E and development expenditures are enhancements of a mineral or oil and gas property and should be accounted for accordingly.

In Canada, the majority of companies in the oil and gas industry use the full cost method of accounting for E&E costs as found in Accounting Guideline 16 *Oil and Gas Accounting – Full Cost*. Though not identical, the accounting model proposed in the DP has many similar features to Accounting Guideline 16. We believe that capitalizing E&E costs accurately represents the existence of one asset comprised of both the legal right to explore and extract as well as information about a property obtained through exploration and evaluation activities.

Though not representative of fair value, we believe that the capitalization of E&E costs provides useful information to stakeholders. It communicates the amount that the company has spent on its properties, net of impairment. Expensing E&E costs as incurred does not accurately reflect the investment life cycle of an upstream oil and gas or mineral property.

Question 7 – Testing exploration properties for impairment

We agree with the project team's conclusion that during the E&E phase, management will likely not have sufficient information to estimate a recoverable amount. We generally agree with the proposed approach for testing for impairment of exploration assets (referred to as Option C in the DP). We also agree with the following disclosure proposed in paragraph 4.74 of the DP for:

- separate presentation of exploration properties in the financial statements, and
- for properties written down in the period, disclosure of the factors that led management to determine impairment of exploration properties and for properties not written down in the period, disclosure of managements' views on why those properties should continue to be capitalized.

We agree with the conclusion in paragraph 4.75 of the DP that such disclosures will safeguard against unduly optimistic or pessimistic estimates of recoverable amounts. In particular, the obligation for management to explain the reasons for continued capitalization will encourage management to appropriately consider the need to write-down these assets.

We do not support addressing impairment using the Option A discussed in the DP. As addressed in our response to Question 6, we think that the costs incurred during the E&E activities should be capitalized.

We do not support addressing impairment using the Option B discussed in the DP. The "undue cost or effort" criteria in Option B is subjective and would arguably be met in most cases during the exploration stage because there would not be sufficient information to indicate the existence of economically recoverable quantities of minerals or oil and gas. Given this, expenditures on most properties in the exploration and evaluation stage would be written off when incurred. Option B includes the possibility of reinstating these costs at a later stage as a reversal of an impairment. We do not think that expensing E&E costs when incurred and subsequently reversing such costs appropriately reflects the nature of the asset that E&E expenditures represent.

Appendix B
Ontario Securities Commission and
Autorité des Marchés Financiers

Of the CSA's approximately 569 oil and gas reporting issuers, 9% are principally regulated by the Ontario Securities Commission and 2% by the Autorité des Marchés Financiers in Québec. Of the CSA's approximately 1,646 reporting issuers in the mineral extraction industry, 24% are principally regulated by the Ontario Securities Commission and 6% by the Autorité des Marchés Financiers in Québec.

Question 4 – Minerals or oil and gas asset recognition model – recognition

Considering the *Framework* as it exists now, and the tentative revisions that the IASB has made to the definition of an asset, we believe that a legal right to explore a geographic area constitutes an asset for the reasons stated in the discussion paper. We do not agree, however, with the project team that exploration produces information that is an enhancement to the mineral or oil and gas property asset. We consider that an asset constituting legal right(s) to explore and extract are recognizable regardless of the existence, or non-existence, of extractable deposits within the property. However, if such deposits are revealed as a result of exploration activity, then we believe these would separately meet the definition of an asset both under the current and tentative revised *Conceptual Framework* definitions.

We have concerns, particularly in the early stages of exploration before there is any indication of the existence of a reserve or resource, with the capitalization of exploration and evaluation (E&E) costs given the high degree of uncertainty around whether a property will have any underlying deposits and therefore that future cash inflow will be obtained. We believe that the capitalization of E&E costs prior to the discovery of any underlying resource is not supported by either probable future benefits occurring from that exploration (a current *Framework* requirement), or the known existence of a deposit as a present economic resource (tentative *Framework)*. We believe the costs of information gathering through E&E should be viewed not as enhancements to the legal right but as costs incurred to determine whether there is another asset that the entity has – i.e., a mineral or petroleum deposit. Whether the exploration results in future benefits to the entity depends on the results of that information and not by the activity of seeking information per se. We note that many other industries, such as the bio-technology or software industries, expend significant resources on research and other information generating activities where there is high uncertainty whether initial expenditures will be recoverable. In those industries, assets are not recognized in a manner proposed by the project team. We recognize that cumulative cost information may be useful and relevant for investors, however this information can be adequately provided by way of note disclosure.

Although we do not have a strong view as to the level of confidence that would be necessary to record a mineral or oil and gas asset, the IASB may want to consider whether sufficient evidence of a present economic resource equates to a definition of

resource or reserve in PRMS/CRIRSCO. Commencing capitalization of E&E costs could be tied to successfully achieving one of these predefined categories of reserves and resources. Alternatively, the assessment as to whether a mineral or oil and gas asset exists could be based on management's judgement, however in this case we believe it would be necessary to provide sufficient guidance in order to achieve a reasonable level of consistent application across entities.

Additional points that support our view:

- legal right and the underlying mineral resource have different characteristics, therefore should be accounted for as separate assets
- different methods of depreciation/depletion and differing useful lives of the legal rights compared to the developed mine or well, suggest that the two assets have different characteristics
- the legal right is intangible and the underlying deposits are tangible - indicating different characteristics which would suggest they are separate assets.
- grouping the two asset together could be appropriate in many cases, given relationship between the two assets and the cost of obtaining legal rights may be immaterial in many cases

We consider that mineral and petroleum deposits that meet the definition of an asset should be accounted for as one unit of account when they are lying within, or accessible from a single geographical area, or group of contiguous areas, which are managed separately and which would generate largely independent cash flows from other deposits recognized by the entity.

Question 7 – Testing exploration properties for impairment

We believe that the impairment test recommended by the project team (*Option C – Identifying indications of impairment that are different from those in IAS 36*) for phases prior to the development phase is not strong enough to prevent costs being recognized on the balance sheet at amounts higher than the recoverable cash inflows that would be expected based on the current level of knowledge regarding any resources or reserves associated with a property. The recommended impairment test relies solely on management's judgement without indications of what that judgement should be based upon. Under the project team's proposal, we believe that there are insufficient safeguards to prevent an entity from making unduly optimistic or pessimistic estimates and are concerned that the application of the impairment test would not be applied consistently across entities.

We support *Option A – revisiting the project's team view on initial recognition*, in order to explore further the viewpoint that reserves and resources may be distinct assets separate from the legal right asset. As assets would only be recognized once there were considered to be present economic resources, we consider that an approach broadly based on IAS 36 could be applied to both a legal right (akin to other intangible assets) and a mineral or petroleum asset. Additional guidance on specific indicators of impairment applicable to the extractive industries, and on performing a "fair value less costs to sell"

calculation on the occasions where there may be challenges in determining a reliable discounted cash flow analysis for calculating value-in-use, would be useful in such a situation.

We believe that *Option B – Undue cost or effort exemption* provides a better alternative than *Option C* recommended by the project team. The benefit of option B over option C is that it would require the asset to be written down to $0 when there was undue cost or effort. This would require management to make a positive and supportable assertion about an asset's recoverable amount in order to recognize an asset. This option also has the advantage that at the time that an expected cash flow can be calculated, any impairment can be reversed up to the point that would have been recognized had no impairment been taken, which allows an entity to recognize costs incurred on activities that do lead to the ability to extract deposits, but not those where the activities do not lead to actual reserves or resources (and no access to future benefits).