Funding Dangers Posed by Extractive Industries International Accounting Standard

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Abstract

Rapid implementation of the International Accounting Standards (IAS) for public financial reporting is taking place globally. European companies are required to convert to IAS by 2005. The author expects substantial acceptance of IAS in the U.S. and Canada by near that date. IAS provides for the current value of assets to be reported in the primary financial reports of companies.

In November 2000, the Extractive Industries Steering Committee of the International Accounting Standards Committee (IASC) released an Issues Paper seeking replies by 30 June 2001. Based on the responses received, the committee is scheduled to develop an accounting standard for the mining and petroleum industries for release in the fourth quarter of 2002 as part of IAS.

The tentative views expressed by the IASC steering committee have a *deja vu* resemblance to the U.S. Securities and Exchange Commission's perspective expressed in its highly restrictive and antiquated *Industry Guide 7*. The question of whether to allow quantitative reporting of resources that are not reserves, as supplemental information, appears to have only barely remained on the edge of the table for discussion. The possibility of reporting an estimate of the current value of any category of such resources did not even reach the table. Disclosure of the current value of reserves would be restricted to a supplemental information section. If the standard is finalized with this perspective, the restriction to an historic cost accounting basis for reserves and resources will greatly handicap the financial abilities of the mining and petroleum industries relative to other industries allowed current value accounting of assets.

The author is the U.S. representative to the Extractive Industries Task Force of the International Valuation Standards Committee (IVSC), a sister organization to the International Accounting Standards Board (IASB), which replaced the IASC through restructuring in December 2000. The task force members are assisting the IVSC in developing its input to the IASB. The author seeks active minerals industry support and sponsorship for his and the task force's initiative to modify the outcome to an appropriate current value standard for the extractive industries, based on an international minerals valuation standard, the urgent development of which he expects the task force will need to undertake.

Introduction

The International Accounting Standards (IAS) are being rapidly introduced globally, including in North America. This is a current value accounting system for reporting of financial accounts to the public, allowing the reporting of the current appreciated value of assets in the primary financial statements. The accounting systems to be phased out in the U.S. and Canada, base the reporting of asset value on historic cost without allowance for appreciation in value.

The accounting standard for the mining and petroleum industries is scheduled for finalization in late 2002. The tentative views have been expressed by the steering committee developing the standard, in its Issues Paper released in November 2000 by the International Accounting Standards Committee (IASC), along with a request for feedback by 30 June 2001 for questions posed. The most important tentative opinions expressed are: (1) the extractive industries should be restricted to historic cost accounting for the value of reserves in primary financial statements; and (2) quantitative and current value estimates for reserves should be restricted to the supplemental information section of the report. The question of whether to allow quantitative reporting of resources that are not reserves, as supplemental information, appears to have only barely remained on the edge of the table for discussion. The possibility of reporting an estimate of the current value of any category of such resources did not even reach the table.

The author is the invited volunteer U.S. representative to the Extractive Industries Task Force of the International Valuation Standards Committee (IVSC), a sister organization to the IASC. Through this task force and other means, he is hopeful that the outcome can be modified to an appropriate current value standard for the extractive industries. This would need to be based on an international minerals valuation standard, the urgent development of which he expects the task force will need to undertake. The author seeks active minerals industry support and sponsorship for his and the task force's initiative. Prior to his attempts beginning late last year to bring these issues to the attention of members of the extractive industries through his writings and talks at meetings, the author found absolutely zero awareness of them among industry colleagues nationally and internationally. He has yet to meet an industry member aware of these developments who was not made aware through the author's efforts.

In this paper, the author first concentrates on explaining the development and implementation of IAS and the sister International Valuation Standards (IVS), and their global adoption which is currently taking place. He then discusses the very negative direction of the IASC's extractive industries standard development in regard to quantitative and value reporting of reserves and resources.

The opinions expressed are the author's, not of the American Institute of Minerals Appraisers, and should not be taken as necessarily aligning with the perspectives of the other members of the IVSC Extractive Industries Task Force. Being a geologist and minerals economist, not an accountant, he apologizes in advance for any misconceptions he may convey regarding the specifics of accounting.

Global Adoption of the International Accounting and Valuation Standards

The International Accounting Standards Committee, which is based in London, was formed in 1973, "with the objective of harmonising the accounting principles which are used by businesses and other organisations for financial reporting around the world." Its members consist of 153 professional accounting bodies in 112 countries. It has close relationships with all major international financial and economic bodies. The U.S. Securities and Exchange Commission (SEC) has been having formal meetings with it since 1983. In 1987, IASC published its first bound volume of International Accounting Standards (IAS). In the same year, the International Organization of Securities Commissions (IOSCO) joined the IASC's consultative group in a supporting role, followed in 1988 by the U.S. Financial Accounting Standards Board (FASB).

In 1998 IASC completed the major components of the core set of Standards, as identified in an agreement with IOSCO in July 1995. The core standards provide a comprehensive basis of accounting, covering all the major areas of importance to general businesses. They will result in transparency and comparability and they provide for full disclosure. In May 2000, IOSCO recommended that its members endorse the use of IAS by companies with cross-border offerings and listings. However, the extractive industries and some other sectors are excluded from this approval, because they have specialized reporting practices falling outside of the scope of the 30 standards approved by IOSCO resulting from the IAS core standards work program.

Many countries have already adopted IAS as their own, some with minor changes. Some others, such as Australia, have been modifying their standards to match or harmonize with IAS. In June 2000, the European Commission announced that all European Union companies listed on the securities markets should prepare their accounts using IAS by 2005, and is considering advancing that deadline. The U.S., Canada and Japan are the slowest to adopt IAS, but that adoption is accelerating rapidly. The U.S. and Canada are working on a policy of rapidly converging IAS with their Generally Accepted Accounting Principles (GAAP) systems of accounting to effectively merge into one system, rather than outright adoption of IAS. The timescale for convergence appears to be only a few years, with the end result being effective adoption of IAS. Nevertheless, a discussion paper released by the Canadian Securities Administrators (CSA) on 16 March 2001, together with other indications, suggest that Canada will likely further accelerate acceptance and adoption of IAS by abandoning its convergence initiative, and allow IAS filings without reconciliation to GAAP (CSA, 2001).

During the past year, IASC has undergone a major restructuring, matching the transition from IAS development to global implementation. The volunteer board has been replaced by a paid board of primarily full time members, with heavy U.S. and European representation. This new organization is called the International Accounting Standards Board (IASB). The U.S. will be funding a substantial portion of the IASB's expanded annual budget of approximately £15 million (over $20 million).

The reporting of the value of assets is the area of most important difference between IAS and the U.S. and Canadian GAAP systems of accounting. GAAP dictates reporting of asset value based on their historic cost. Each year the value of the asset is adjusted downward by depreciation, amortization or depletion. Addition of asset value to the accounts requires that an expenditure be capitalized. GAAP can provide accuracy to the cent in reporting to shareholders the depreciated value of a high rise New York office building that a company has held for 20 years. It is an extremely precise accounting system. But, GAAP's accuracy is horrible. While the value of the office building is now reported in the accounts to stockholders at less than half its purchase price, the building's market value may have increased 5-fold. With a 10-fold inaccuracy in the value reported, the company is a takeover target. IAS solves this serious problem by allowing current value reporting for assets in the primary financial accounts of companies. Many companies in Europe that have adopted IAS, have the value of their major assets, particularly real estate, reappraised every two or three years. Those current asset values are entered into the accounts, then depreciation and amortization begin again.

IAS allows companies to retain historic cost accounting if they prefer. However, once companies adjust their accounting systems to IAS, it will in general benefit them to move to current value reporting for assets. In addition to providing the shareholder and financial community with a much more accurate statement of company assets, it will generally benefit companies by reporting much higher values for their appreciated assets. This will tend to elevate the price of their shares and aid fund raising.

The International Valuation Standards Committee, which is also based in London, was founded in Melbourne, Australia in 1981, with a primary objective, "To develop truly international standards of valuation and reporting that meet the needs of financial reporting, international property markets and the international business community."[1] From the perspective of international financial reporting standards, IVSC can be viewed as an important small sister to IASB. IVSC is developing the standards for appraising the value of assets that are reported at current value under IAS. However, the intended applications of the IVSC standards cover the broader spectrum of uses for formal valuations.

IVSC published the first edition of the International Valuation Standards (IVS) in 1985. The 2000 edition is a very comprehensive, well organized book, available in a number of languages (IVSC 2000). The IVS is now recognized throughout the world and has been incorporated into the domestic standards of many nations. The U.S. Appraisal Institute has recently requested that the U.S. Appraisal Foundation's Appraisal Standards Board restructure the Uniform Standards of Professional Appraisal Practice (USPAP) to more closely mirror IVS.

IVS can be viewed as a sister volume to IAS, and is actively promoted by IASB/IASC. IVS contains guidelines for appraising the value of four categories of assets, Real Property, Personal Property, Businesses, and Financial Interests. It also includes a code of ethics and competency provisions for the appraiser (Ellis, 2001).

Institutes from 35 countries maintain full IVSC membership, and another 15 countries have representation. IVSC is a Non-Governmental Organization member of the United Nations, and like IASB works closely with many influential international bodies, such as the World Bank, the Organisation of Economic Cooperation and Development, the International Monetary Fund and the World Trade Organisation.

Near the end of 1999, the standards development initiative of IVSC received a major financial boost through contributions from some of the major appraisal institutes of the world and some corporations. This boost has allowed IVSC to embark on an ambitious three year standards development initiative.

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[1] Outside the U.S., the term *valuation* is generally used instead of the U.S. term *appraisal* when referring to a formal value estimate. Similarly, the terms *valuer* or *valuator* are generally used when referring to the individual professional instead of *appraiser*. The terms are viewed as interchangeable in their use in this paper.

Extractive Industries Accounting Standard Development

IASB and IOSCO view the extractive industries of mining and petroleum as having special accounting considerations not covered by the core standards of IAS. With encouragement by IOSCO, the development of an extractive industries accounting standard was added to the IASC agenda in April 1998. A ten member steering committee was formed to develop the Issues Paper for public comment and then draft the standard. The standard will be for "upstream activities" from exploration through extraction of the first saleable mineral product. It will not cover the "downstream activity" of refining, processing, marketing and distributing, other than refining or processing that is necessary to extract the saleable product.

The 412 page Issues Paper was published in November 2000, together with a 43 page summary (IASC, 2000). Both can be downloaded from the IASB website, www.iasc.org.uk. The comment period ends 30 June 2001. The author compliments the steering committee on the thoroughness of the discussion that is provided in the document.

An exposure draft of the standard is scheduled for release in the first quarter of 2002. The final standard is scheduled for publication in the fourth quarter of 2002. IOSCO intends to adopt the standards, subject to its review.

The Issues Paper requests feedback on more than 150 issues, many of them addressing essential finer points of accounting, but having little or nothing to do with reporting the value of reserves and resources. Others pertain only to petroleum. The Issues Paper also provides the steering committee's tentative view on 35 items. Here the author only addresses the most important issues pertaining to quantitative and value reporting for reserves and resources.

The Steering Committee's tentative recommendations include (by item number):

> 5. *"The primary financial statements of an extractive industries enterprise should be based on historical costs, not on estimated reserve values*."
>
> 6. *"Information about reserve quantities and values, and changes in them, should be disclosed as supplemental information*."
>
> 33. *"Disclose proved and probable reserves separately, and within proved disclose proved developed and proved undeveloped reserves separately*."

In developing these tentative recommendations, the committee expresses conflict and reservation over the concept of reporting quantitative reserves estimates within the mining industry, due to the lack of standardization within industry as to the economic inputs used in estimating a reserve under the Australasian JORC Code (JORC, 1999). It also has difficulty with the difference in philosophy for reserve calculations between the mining industry's deterministic JORC definitions and the petroleum industry's probabilistic WPE-SPE definitions. The possibility of the IASB taking control of reserve definitions for its reporting purposes is raised (Chapter 3).

When the issues relating to valuation of reserves are raised, many additional reservations are expressed about inconsistencies across the industry in application of the same and other economic inputs. Statements are present about the lack of standards within the industry for valuation. Discussion of six possible definitions or types of value that could used for determination of current value is provided.

The committee is seeking input on a lengthy list of Basic Issues. Two of particular relevance are:

> Basic Issues 14.4 - Disclosure of mineral resources: *"Should quantities of estimated mineral 'resources' be disclosed, and if so what categories of resources should be disclosed?*"

> Basic Issue 15.2 - Value of properties held for exploration: *"Should the value of mineral properties held for exploration be disclosed?"*

The question of disclosure of non-reserve mineral resources (14-4) appears to have been somewhat grudgingly included after an example WMC disclosure in Chapter 14. Discussion contained in Chapter 3 seemed to have weighed in against such disclosure to the extent that this author is surprised that the question was raised.

Regarding 15.2, it must be noted that here the committee is only considering whether to disclose value based on historical cost. The question of whether to allow disclosure of estimates of current value even for non-reserve mineral resources in the supplemental information, did not reach the table.

In reviewing the Issues Paper, the author developed a substantial sense of *deja vu*. This is due to the resemblance of the steering committee's opinions to those expressed by the SEC's mining professionals, and cast in its highly restrictive and antiquated *Industry Guide 7*, first instituted in March 1981 in Form S-18 with identical wording (SEC, 1992). The author understands from discussions that the SEC has had substantial input to the steering committee. Although the author views the SEC's position as being antiquated, the committee raises a raft of valid concerns that our industry must address.

International Valuation Standards Committee's Input

In late January 2001, the author was contacted by the IVSC to assist it in developing its response to the Issues Paper. As discussed above, the IVSC has a long, close relationship with the IASB/IASC. Its input can be expected to be reviewed carefully by the steering committee. An IVSC representative is often appointed to the IASC committees that author standards.

With the author's assistance, the following task force of independent expert minerals appraisers (valuators) was quickly assembled:

Trevor Ellis representing the U.S.
    President, American Institute of Minerals Appraisers
Michael Lawrence representing Australasia
    Chairman, AusIMM's VALMIN Code Committee
William Roscoe representing Canada (Ross Lawrence, alternate)
    Co-Chair, CIM's Special Committee on Valuation
Roger Sawyers representing the U.K.
    Chartered member, Royal Institute of Chartered Surveyors

In July 2000, the IVSC raised with the author the possibility of him assisting with the development of a set of extractive industry valuation guidelines for inclusion in IVS. The author has suggested to IVSC that the task force may need to draft such standards on a high priority basis, to alleviate some of the serious concerns expressed in the Issues Paper. This possibility will be raised with the IVSC board. However, whether such a complex undertaking could be conducted in a timely manner within the time-frame of the IASB drafting the extractive industry standards, is uncertain. The AusIMM's VALMIN Code could provide a good beginning, but would need substantial restructuring (AusIMM, 1998; Ellis, 2000). Whether the IASB might be willing to draft its standard based on the promise of a mineral valuation standard being introduced at a later time is unknown. Getting the IVSC to change the standard in a few years time may prove difficult. If the project is to be undertaken, industry will need to provide the task force with financial support, as this is a much larger, important and expensive project than should be undertaken on a volunteer basis.

Conclusions and Recommendations

If the IAS extractive industries standard is developed by the IASB/IASC extractive industries steering committee around the tentative opinions expressed in the Issues Paper, the share prices of mining and petroleum companies will be significantly depressed relative to shares of companies in other industries. This is because there will be a severe dislocation between the current value reporting allowed for assets of most industries in their primary financial accounts, and the historic value reporting for the major assets (reserves) which will be required for the extractive industries in their primary accounts. The resultant depression of the share prices of extractive industry companies will retard their ability to raise funds.

The author recommends that the extractive industries submit to the IASC extractive industries steering committee that:

> Reporting of the current value of proven and probable reserves be allowed in the primary financial accounts.
>
> Quantitative reporting of reserves and resources in the supplemental disclosures should follow the Council of Mining and Metallurgical Institutes' (CMMI) - JORC definitions. It should include proved and probable reserves, and measured, indicated and inferred resource. Any enhancements to the mining industry resource-reserve reporting standards which IASB determines are needed should be made through CMMI..
>
> The current value of measured and indicated resources should be allowed in the supplemental disclosures.
>
> The value of inferred resources and exploration properties be disclosed on an historic cost basis.

The extractive industries undertake a prompt review of their reserve-resource reporting standards to address concerns raised in the IASC Issues Paper

The extractive industries should sponsor the rapid development of a set of mineral valuation standards to work within IVS to address many of the concerns raised in the Issues Paper.

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