

Oil Industry Accounting Committee

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Mr Glenn Brady
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Dear Mr Brady

Comments on Discussion Paper – Extractive Activities

On behalf of the UK Oil Industry Accounting Committee (OIAC), I would like to congratulate the Extractive Activities project team on the discussion paper, which has been many years in gestation and has clearly involved many people in a huge effort. Whilst some of our individual comments may seem rather critical, OIAC absolutely supports the team's objective to harmonise and standardise accounting and disclosure requirements for the upstream side of our industry and fully recognises the scale and difficulty of their task.

About OIAC

OIAC was established in July 1984 following a review by the Accounting Standards Committee (ASC) which recommended a framework of Statements of Recommended Practice (SORP) as a complement to accounting standards. SORPs would relate to particular industries and be developed by accounting bodies drawn from the industries concerned. The objectives of OIAC at its formation were to advance and promote agreement on accounting within the oil and gas industry, in particular to develop SORPs for the upstream oil and gas industry in accordance with guidelines laid down by the ASC.

OIAC issued four Statements of Recommended Practice on individual topics over the period 1986 to 1991. In 2000, these were consolidated into a single SORP for upstream oil and gas activities, entitled "Accounting for Oil and Gas Exploration, Development, Production and Decommissioning Activities", which was updated in 2001.

In June 2002, the EU adopted a regulation that required listed EU companies to adopt International Financial Reporting Standards (IFRS) in their consolidated financial statements from 2005. AIM companies had to follow with effect from 2007. Since this change affected a large majority of OIAC's constituency, our focus switched away from UK GAAP and SORPs and towards IFRS, and in particular the development of IFRS6 and the progress of the Extractive Activities project.

In anticipation of the Extractive Activities discussion paper (the DP), and recognising its likely importance to our industry, OIAC's membership, constitution and terms of reference have been refreshed, with this response to the DP as our first major objective. OIAC's mandate has always been strictly limited to the oil and gas industry and, to date at least, its upstream side.

Accordingly we specifically do not address the issues relating to whether a single standard could meet the requirements of the minerals extraction industry as well.

Form of this response

OIAC's responses to the ten questions posed by the DP are included in the attached Appendix. Whilst studying those particular questions, however, our three working parties identified a number of issues which had an over-arching bearing on our views, and we have brought these higher-level points together below.

1. IASB Endorsement

The DP specifically states that IASB has not endorsed the proposals. In itself, that is not a problem, but the DP also proposes to move straight to an exposure draft if various stepping stones are achieved. It also leaves open some very fundamental issues, such as fair value or historic cost, on which IASB has expended considerable effort in recent years.

In our experience, once an accounting standard proposal reaches the stage of an ED, the scope for material change is limited. A move straight to an ED might be acceptable, but only if there is general agreement on the DP proposals. If, as seems quite likely, there are significant changes resulting from the combination of the consultation process and IASB's own considerations, then we believe that a further "white paper" stage would be appropriate, with full IASB involvement in the new proposals, before moving to an ED.

2. Scope – Depth and Breadth

Although already a weighty document, the DP nevertheless still considers topics at quite a high level. In several areas, our working parties have initially interpreted the DP proposal as being very much in line with current oil and gas industry practice (and therefore probably acceptable) but have then questioned what the future standard might say when it addresses a treatment in detail. This is the stage – present in an ED – at which real practical issues surface from the people who have to implement the new standard.

We would like the project team to give more detailed consideration to some of the areas covered by the broad headings in the paper. For example, on the cost capitalisation question there are common problem areas which arise in relation to abnormal costs, overheads, training costs and componentisation. These issues are not considered within the current paper but could, we believe, reveal application problems when they are.

For very understandable reasons, the DP focuses almost entirely on the big issues of asset accounting and supplementary disclosures. There are also, however, a number of other topics that are very important, certainly for the oil and gas part of the Extractive Activities field, which are not included within the current paper but which we believe would add significant value to any revised proposals. These include:

- Farm outs and unitisations;
- Asset swaps involving assets still within the exploration phase;
- Production sharing contracts;
- Revenue recognition (including accounting for production underlift and overlift);
- Commodity contracts;
- Leases (specifically how the standard should be applied in situations where joint arrangements exist, as there are some inconsistencies with IAS31); and
- Decommissioning (the current Exposure Draft on Liabilities contains proposals which could have significant implications).

OIAC is particularly sensitive to this scope issue because under new UK GAAP proposals its SORP will soon cease to have any role in upstream oil and gas reporting, removing existing guidance on several of these topics. If companies are forced to go back to generic IFRS and interpret how these specialised transactions should fit into the accounting rules that were never designed to cover them, it seems likely that the result will be less, not more, uniformity of treatment and inter-company comparability.

3. Convergence with US GAAP

The current proposals include major differences relative to current SEC/FASB requirements (such as on cost capitalisation and reserve bases). Whilst that need not be at odds with IASB's objective to ensure that all new IFRS proposals are developed in such a way as to facilitate the future IFRS / US GAAP convergence project, there is certainly room for concern.

With a long history in oil and gas exploration and development and the huge weight of their industry on the global energy stage, the USA has led the world for decades in the development of accounting standards for the sector. It is no coincidence that, unless there were very strong reasons to the contrary, OIAC's SORP tended to follow the US methodology as the de facto world standard.

As long ago as 1977, FASB tried to kill off full cost (FC) accounting and standardise on successful efforts (SE). That was thwarted by the industry and overturned by SEC the following year in a move that also introduced Reserve Recognition Accounting – a form of "fair value" accounting, which also flopped and was withdrawn in 1981. The DP proposes an asset accounting method which is neither FC nor SE but somewhere in between, which seems likely to encounter resistance from all sides of the US industry. And it leaves as an open question the issue of fair value accounting, which caused a huge rebellion last time it was tried.

It may be that the Extractive Activities project team has assured itself that SEC/FASB is ready to move away from its entrenched positions and has secured broad agreement for the proposals set out in the DP. If not, we would be alarmed at the possibility that companies with dual reporting obligations might have to follow two divergent sets of requirements for accounting and disclosures. Accordingly, we consider it extremely important that IASB, SEC/FASB and other national securities regulators minimise the differences between their respective standard(s) and, where conflicts cannot be avoided, allow dual-listed companies to choose a single source of standards to follow rather than having to prepare accounts on two (or more) different bases.

4. Process towards IFRS

The DP seems to envisage a single Extractive Activities IFRS emerging as the end result of all their efforts. An alternative approach, which OIAC would support, would be to issue a new "Extractive Activities Disclosures" exposure draft to address the specific need for a standardised approach to the disclosure of reserves and resources, and address other user disclosure requests such as users' desire to see total historical cost expenditures (both capitalised and expensed) to enable them to track total finding costs for the reserves. It may then be possible to address specific questions on accounting through a combination of IFRIC interpretations and revisions to or expansions of current accounting standards, notably IFRS6. If this path were followed, it would be helpful to include the scope breadth and depth issues mentioned above as each piece of the IFRS jig-saw were completed.

I and other members of OIAC would be happy to discuss any of our responses with you in further detail, if that would be helpful.

Yours faithfully

A handwritten signature in dark ink, appearing to read 'Alan R H Thomas', with a long horizontal line extending to the right.

Alan R H Thomas
Chairman
Oil Industry Accounting Committee

APPENDIX

Question 1 – Scope of extractive activities

In Chapter 1 the project team proposes that the scope of an extractive activities IFRS 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.

OIAC believes that the current focus on “upstream activities” is appropriate. Most other activities in the oil and gas sector are reasonably comparable with those in many other industries and should be complying with the same IFRS accounting standards. We recognise a potential grey area in relation to what might normally be considered mid-stream investments (pipelines, LNG liquefaction plants, etc) where the asset is operationally and economically integrated with the oil or gas field development. Consideration should be given, prior to any Extractive Activities exposure draft, to the question of whether the investment and operating costs of such highly-integrated mid-stream activities should be incorporated into the supplementary upstream disclosure requirements.

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?

Whilst some of our individual members have some knowledge and experience of the minerals industry, OIAC’s constituency and mandate are strictly limited to the oil and gas industry. Accordingly, we refrain from expressing a view as to whether a single or separate standard should be issued. We believe that there may be similarities between the minerals and oil and gas industries, but we suspect that at the very detailed level involved in implementing any new standard, some quite profound differences may emerge. However, our main concern would be that the oil and gas-related issues raised in our introductory letter are addressed.

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?

OIAC supports in principle the use of definitions that have been developed by the Society of Petroleum Engineers (SPE) for use in an IFRS for Extractive Activities. However, in light of the potential issues that could arise should the SPE make changes to the Petroleum Resource Management System (PRMS), we believe the definitions should be “hardcoded” into IFRS, dealing with future updates as and when they arise. This would be similar to the approach adopted by the SEC.

We also believe that users of financial statements expect economic assumptions supporting reserves disclosures to be standardised. In order to achieve this we suggest that the definitions set out in a future standard (picked up from SPE) are accompanied by similar requirements to those in the current SEC rules to ensure consistent pricing and cost assumptions. This is an alternative scenario acceptable to the SPE (as set out in paragraph 2.34 of the DP) and renders much of debate regarding economic assumptions (beginning in paragraph 2.49) unnecessary.

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 recognised 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 recognised and when should they be recognised initially?

OIAC considers that the proposal to treat the legal rights as the basis of a 'minerals or oil and gas property' asset is an elegant principle on which to build the subsequent asset recognition and accounting rules. Given that basic foundation, it is clear that such an asset should be recognised only from when the legal rights are acquired. As indicated in our response to question 6, OIAC strongly supports an historic cost approach, which defines what we believe should be booked when legal rights are acquired.

Treating subsequent exploration and evaluation (E&E) activities as enhancements to the legal rights should lead to an outcome which is consistent with existing practice in the oil and gas industry. Conversely, expensing such items would result in non-recognition of items which preparers and users are accustomed to treating as 'assets' and which represent a significant investment in an entity's future, rather than current period performance. OIAC would not support the expensing approach.

However, OIAC has reservations about the presumption reflected in the DP, that such activities enhance the legal rights asset. Statistically, only a minority of exploration projects ultimately proceed into development, and it follows that the 'value' of most legal rights assets will diminish to nil as the information acquired during the exploration and evaluation process becomes known. In this context, it would appear counterintuitive to capitalise costs of E&E which yielded information about the underlying asset which was manifestly adverse, which could be the outcome of the DP proposals as drafted. Whilst the requirement for an impairment test would provide a 'safeguard' over the aggregate carrying value of a legal right and its associated expenditures, for the factors discussed in our response to question 7 below we consider that an impairment review of E&E assets may not be a particularly robust safeguard, and therefore a more conservative approach to adding costs to the balance sheet is warranted.

As a possible solution, OIAC considers that E&E work in progress (i.e. E&E investment prior to the information it yields becoming known) might meet the criteria for recognition as an asset, separately from the related legal right. This 'information asset' might then be accumulated as an enhancement of the underlying legal rights, and become part of the same unit of account, if the information it yields so justifies; otherwise the information asset would not be considered as an enhancement and would be derecognised (i.e. expensed).

As a further overarching comment, OIAC understands that the handling of probability in the recognition of assets is under review by the IASB and recommends that the requirements for recognition of E&E assets should be consistent with the results of this review.

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 recognised 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?

OIAC agrees that geographical boundaries represent a key factor in determining the appropriate unit of account. OIAC generally agrees with the concept that the unit of account would contract progressively along the lines described in the DP.

However, the DP is not sufficiently clear on how the accounting for such contraction would operate in practice. For example, E&E costs are often initially incurred across a relatively broad geographic area (such as seismic and other surveys) of which ultimately only a relatively small area may be further explored, evaluated and ultimately developed and produced. It is unclear from the DP whether a proportion of such costs should be allocated to the area outside of that ultimately developed and produced, and then derecognised (expensed), or instead whether such costs should be considered a cost of the area to be developed, in that they were a reasonable cost of identifying it, and thus should remain capitalised.

In the foregoing example, OIAC recommends that such costs should remain capitalised and be allocated to the areas identified from those activities, even though they may have been incurred largely or partially in parts of the licence that were determined ultimately not to be of interest.

More fundamentally, OIAC believes that there are a variety of facts and circumstances which will require more detailed practical guidance than that provided in the DP, in order to achieve a reasonable degree of consistency in application. Whilst OIAC believes that such additional guidance could be provided in a variety of means (such as in an extractive activities IFRS, amendments and supplements to existing IFRSs, worked examples and/or IFRICs) whatever method is chosen the guidance should achieve consistency of application.

Question 6 – Minerals or oil and gas asset measurement model

Chapter 4 identifies current value (such as fair value) 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.

OIAC strongly believes that oil and gas properties should be measured at historic cost, and not at fair value or any other 'current value' measure (referred to collectively as fair value hereinafter).

OIAC generally concurs with the deficiencies identified in the DP in relation to the use of fair value as the measurement basis for oil and gas properties, and believes these to be so significant as to render fair value inappropriate as a measurement basis. In addition to cost-benefit considerations, OIAC believes that the fair value of any oil and gas property, and in particular E&E stage properties, is highly subjective. Any attempt to recognise a single fair value in the financial statements would be a fundamentally misleading over-simplification, and introduce excessive room for bias on the part of preparers.

Moreover, whilst OIAC concurs that historic cost as a measurement basis has limitations, most notably in the relationship between net book value of the upstream assets and their possible value in use or to a buyer, OIAC disagrees strongly with the suggestion that comes through broadly in the DP that historic cost information is not of significant value to accounts users. OIAC's membership includes both accounts preparers and accounts users and in their experience, historic cost information is an important input into widely used performance measures such as ROCE and reserves finding costs. OIAC believes that historic cost information provides relevant, reliable information about the economic resources invested by an entity in generating added value.

Such added value is primarily reflected in increases in oil and gas quantities discovered but not yet produced by the entity in the period.

OIAC believes that reporting of financial performance requires information about both the economic resources invested by an entity, and the value added by that investment. This is

best achieved through the recognition of oil and gas properties at historic cost supplemented by disclosures about reserves (see response below).

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 judgement, 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 recognised 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?

The issues in measuring reliably the fair value of an E&E stage property are equally applicable to the measurement of the recoverable amount of an E&E stage property, and this should be reflected in the impairment testing (and de-recognition) requirements for such properties.

OIAC believes that many of the existing criteria typically applied in 'writing off' E&E assets (such as those reflected in IFRS 6 paragraph 20 and in US GAAP) remain suitable, and concurs that these are most appropriately dealt with in a future IFRS as a set of de-recognition indicators, rather than as impairment indicators, as proposed in the DP.

Whilst an E&E asset remains recognised as such, OIAC agrees that impairment indicators other than those in IAS 36 are necessary to ensure that E&E properties are not required to be tested for impairment before sufficient information exists to perform a reliable impairment test. Whilst OIAC has reservations about the expression "high likelihood that the carrying amount will not be recoverable in full" (and considers that another expression such as "sufficient information to determine reliably that the carrying amount will not be recoverable in full" might be better), OIAC is nonetheless supportive of the proposals in the DP in principle.

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?

Disclosures are a general area of IFRSs that require attention, and we understand that work on a disclosure "framework" may be planned. IFRS disclosures should meet the general criteria to provide information that help users in making investment decisions, which includes assessing the stewardship of management, and be judged against the qualitative characteristics of financial statements. We do not think it necessary that individual accounting standards should have their own disclosure objectives. Bearing that in mind, the listed objectives may be acceptable although we miss any reference to qualitative characteristics such as reliability, comparability, timeliness and a balance between benefit and cost.

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?

OIAC does not believe that the extra cost and preparation time that would be involved in preparing the disclosure package outlined in Chapter 5 can be justified, and certain of the proposed disclosures would not produce meaningful information.

OIAC's view is that comparability between entities when presenting reserve volumes, i.e. the use of consistent assumptions would be preferable to extensive value based reserves disclosures. More specifically, the proposed use of forecast prices by the project team is not consistent with the assertion that most users would like consistent and objectively determined assumptions (paragraph 5.52).

Reserve valuations are considered to be of limited value, particularly if based on non-standardised assumptions. Restricting disclosures to quantities would be consistent with the underlying purpose of reserve definitions set out in paragraph 2.2 of the DP to "communicate information about the quantity (emphasis added) of minerals or oil and gas ...".

There is also an internal inconsistency in the DP proposals, which require quantities to be determined based on management price assumptions and current value to be determined based on standardised price assumptions.

OIAC believes that the proposed sensitivity analysis would not in practice provide meaningful or useful information because so many of the elements are inter-related. A change in one assumption cannot be assessed without consideration being given to the impact on other assumptions.

Reserve volumes and results of equity-accounted investments should be disclosed because these can form a significant part of an entity's activities. Disclosures of unit prices are considered more useful than of revenues. We also believe that disclosures of costs incurred would be more relevant than cash outflows; they would also be significantly less costly to provide as accounting systems are not usually designed for reporting on a cash basis.

In principle, OIAC recognises the value of disclosing proven plus probable reserves as the (imperfect but) best approximation at a given point in time of the estimated reserves that will be recovered over a field's life under a given set of working assumptions. We acknowledge, however, that the value of this additional disclosure will mainly accrue to investors in smaller and mid-size companies, while it will raise significant incremental cost considerations for the largest companies, for whom the benefits are less. OIAC would therefore support a lesser disclosure requirement where only the disclosure of proved reserves information is compulsory, but which permits the optional disclosure of proved plus probable reserves data, as long as the same strict rules are a requirement for the optional additional disclosures, to ensure comparability.

The DP does not discuss which entities should present the disclosures proposed by the DP but we believe that these disclosures should not be mandated at a subsidiary company level as they would significantly increase the time and effort required to generate disclosures for relatively little benefit.

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 organisations. 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.

In our opinion the proposed Publish What You Pay disclosures should not be required to be included within the notes to the financial statements. We do not believe that this area is an "accounting" issue and, therefore, do not think that it should form part of any accounting standard.

We would also question whether it should form part of any disclosure standard. We think that there would be significant practical difficulties in preparing the information which would be required to produce the suggested disclosures, particularly for integrated oil companies. The processes and information systems which would allow such information to be collected are not currently in place on a widespread basis. Therefore, we do not consider the proposals to be justifiable on cost-benefit grounds.

We expect that the IASB will judge these disclosures using the same criteria that they would apply to any item for inclusion in an IFRS, and therefore we have not restricted our comments to cost-benefit considerations. IFRSs have a different purpose and the Publish What You Pay (PWYP) proposals should be judged against the qualitative characteristics set out in the IASB Framework whose attributes are considered to make the information provided in financial statements useful to investors in their decision-making. The key qualitative characteristics of financial statements in the Framework against which the PWYP proposals should be considered are relevance (which includes materiality) and the balance between benefit and cost.

According to the Framework, "Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements." IAS 1 Presentation of Financial Statements (paragraph 31) states that "An entity need not provide a specific disclosure required by an IFRS if the information is not material". Therefore, even if the PWYP proposals were to be included in a subsequent IFRS, an entity would only include disclosures in its financial statements that were judged to influence the economic decisions of users. In many cases the information for an individual country would not meet this criterion, in which case the coalition would not achieve its purpose in identifying total amounts by country (which would anyway only be for those entities reporting under IFRS). An entity must already consider materiality in making appropriate disclosures in accordance with Chapter 5. Therefore, to the extent that these overlap with Chapter 6 (for example in determining the geographical analysis for reserves volumes, including production, and valuations), an entity would already have made a judgement on the level of detail required and could not provide more detail for the PWYP disclosures.

We also do not see the disclosure of payments of the type discussed to be an issue which is specific to extractive activities, and should instead be considered as a broader multi-industry issue.