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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **16 October 2006, London**

Project: **Extractive Activities research project**

Subject: **Other valuation options (Agenda Paper 4F)**

Purpose

1. The research project team's analysis has presupposed that fair value would be both the initial and subsequent measurement objective for reserves and resources. The purpose of this paper is to identify and briefly consider other valuation models that could be applied, either for balance sheet measurement purposes or disclosure purposes.

2. The research project team has not consulted with the Advisory Panel on the potential application of these options, with the exception of some preliminary research on disclosures. The intention of this paper is merely to highlight some of the options that may provide value-based information relating to reserves and resources.

Options

3. Options for providing value-based information other than fair value include:

   (a) for balance sheet measurement purposes:

      (i) discovery value accounting;

      (ii) reserve recognition accounting; or

(b) disclosure of reserve and resource value-based information.

Discovery Value

4. Discovery value accounting was previously identified as an option when FAS 19 *Financial Accounting and Reporting by Oil and Gas Producing Companies* was being developed. FAS 19.120 describes discovery value as:

> Under discovery value accounting as it has generally been proposed, mineral reserves would be recorded at their estimated value when the reserves are discovered or, alternatively, when the reserves are developed. Property acquisition costs and other prediscovery costs generally would be deferred and written off when the areas to which the costs apply have been explored and the underlying reserves, if any, evaluated. Subsequent to discovery, the carrying amount of the reserves would not be adjusted for changes in prices; however, the carrying amount would be adjusted for revisions of estimated reserve quantities. The discovery value would be treated as revenue from the oil and gas exploration activities of the enterprise and would become the recorded value ("cost") of reserves for future accounting purposes. Those discovery value amounts would then be amortized against the revenues resulting from the production and sale of the minerals.

5. There appears to be some flexibility as to when to define the point of initial recognition of the asset for discovery value accounting purposes. For instance, this may be:

(a) the discovery of any probable reserves;

(b) the point at which reserves are classified as proved; or

(c) the point at which reserves are classified as proved developed.

Advantages of discovery value

6. The advantages of the discovery value method may include:

(a) discovery value accounting provides the best means of measuring and reporting the contribution to income of exploration activities;

(b) value of reserves are more relevant to users of financial statements than historical costs;

(c) discovery value is relatively simple to apply as once discovery value has been determined, the accounting is like historical cost accounting; and

(d) discovery value accounting is relevant to users of financial statements because it matches costs incurred searching for reserves with the increase in value resulting from those costs.

Disadvantages of discovery value

7. The disadvantages of the discovery value method may include:

   (a) the carrying amount quickly loses relevance after discovery;

   (b) the method does not solve problems to do with verification, comparability and neutrality;

   (c) the accounting may influence timing of business decisions – that is, it may provide incentive to bring forward investment decisions so income can be recognised;

   (d) discovery value recognises revenue at the point of discovery/development and it may be some years before the product is produced and sold, which goes against normal revenue recognition principles where revenue is normally recognised at the point of an exchange transaction; and

   (e) the method perpetuates a mixed measurement model as the carrying amount of the asset will include the fair value of the discovery and the historical costs associated with development as well as any further evaluation, production costs etc (although it is noted that this is no different to current accounting where an undeveloped, or in development, property has been acquired).

Reserve recognition accounting

8. Reserve Recognition Accounting (RRA) was proposed by the SEC as a new method of accounting based on valuations of proved oil & gas reserves would replace both the successful efforts and full cost methods.

9. RRA involves recognising:

   (a) proved oil & gas reserves as assets in the balance sheet;

   (b) additions to proved reserves and changes in valuations of proved reserves in the income statement; and

   (c) all costs associated with finding and developing additions to proved reserves, together with all costs determined to be non-productive during the current period, in the income statement.

Advantages of RRA

10. The advantages of RRA were claimed to be that:

    (a) significant improvements in the communication of financial position and operating results of oil & gas producers would be achieved by recognising, in financial statements, proved oil & gas reserves as assets and changes in proved oil & gas reserves in earnings (it was noted that traditional methods of accounting are limited in providing this information on a timely basis);

    (b) RRA would give more appropriate recognition to the discovery of oil & gas, which is the most significant event in exploration, development and production activities;

    (c) RRA would effectively portray the economic resources and the earning process of oil & gas producers during periods of stable or declining prices as well as during periods of rising prices; and

    (d) disclosures of financial and operating data required by RRA would enable investors and government policy-makers to gain an understanding of the financial position and operating results of the company and to compare the financial position and operating results of different companies.

Disadvantages of RRA

11. The disadvantages of RRA were claimed to be that:

    (a) there is an inherent imprecision of estimates of proved oil & gas reserves and there is a need to establish a standard of valuations of these reserves in order to achieve an acceptable degree of reliability; and

    (b) an acceptable level of reliability is necessary before data should be required in public reports and an even higher degree of reliability is necessary before it should be incorporated into the primary financial statements. It was noted that oil & gas reserves cannot be measured directly – they can only be estimated – and such estimates cannot achieve high precision in many cases. Furthermore, placing a valuation on estimated quantities of oil & gas reserves involves additional estimates that are also imprecise.

Disclosures

12. The research project team's preliminary view is that discovery value accounting and RRA would not be suitable for balance sheet measurement of reserves and resources for many of the reasons listed above, noting that those reasons have also been identified as reasons why fair value of reserves and resources is not a suitable measurement objective (refer Agenda Paper 4D).

13. The research project team's preliminary view is therefore that the research should consider identifying and assessing disclosures that can provide users with value-based information that may be decision-useful. In identifying possible disclosure solutions, the research project team notes that the disclosures must satisfy the qualitative characteristics of decision-useful financial reporting information and that the disclosures must also be suitable from a cost-benefit perspective.

14. Some of the disclosure ideas include:

    (a) a valuation or standardised measure on a discounted cash flow basis of select categories of reserves;

    (b) sensitivities of estimates of reserve volumes to changes in key assumptions (e.g. prices, discount rates); and

    (c) forecast production or cost profiles (or similar inputs) that provide users will additional information to include in their valuation models.