Accounting regulation of extractive industries

Finance

Synopsis Lecture: Corinne L. Cortese., Helen, J. Irvine and Mary A. Kaidonis. . ‘ Powerful players: howconstituents captured the setting of IFRS 6, an accounting standard for the extractive industries’, Accounting forum 34, pp 76-88.

Synopsis of the article

The article illustrates that powerful players influenced the setting of International Financial Reporting Standard (IFRS) for the extractive industries. The authors use a Critical Discourse Analysis (CDA) to identity the key players, the surrounding discourses and implications for the extractive industry.

Extractive industries play a critical role in global economic and political relations and include companies in oil, gas and mining industries such as Exxon Mobil, Anglo American and Royal Dutch/Shell Group. The economic power of extractive industries is evidenced by the US $ 211 trillion in profits that was recorded by 20 extractive industries in 2005 compared with United States GDP of US $ 11 trillion in 2005. Efforts to regulate the extractive industry were initiated by the International Accounting Standards Committee (IASC), now the International Accounting Standards Board (IASB) in 1998 in order to address the problem associated with differing accounting practices used by the companies in the sector (Cortese, Irvine and Kaidonis, 2010). The previous accounting standards such as IAS 16 on property, plant, and equipment and IAS 38 on intangible assets did not address the thorny issue of accounting for extractive operations in oil, gas and mining operations. In this case, IFRS 6, exploration for and evaluation of Mineral Resources was released in 2004, but experts in the field claims that the standard codified the existing industry practice and provided the companies with flexibility to continue reporting in their preferred mode (Nobes & Parker 2008).

Background

The impact of the reported profits can be substantial and thus IASC sought to address the discrepancies at the international level. Proponents of full cost method stressed the need to retain the two methods and an Ad Hoc Committee on full costing consisting of various industry bodies and players was constituted (Nobes & Parker 2008). Companies in extractive industries have global operations and diversity in their accounting and reporting has evolved in leading mining regions such as South Africa, Canada, the United Kingdom, Australia and the United States (US). Wiecek & Young (2010) explains that the economic importance of extractive industries led IASC to recognise the need for an international accounting standard that would provide investors and other financial information users with reliable, relevant and comparable financial information to facilitate decision-making.

Cortese, Irvine and Kaidonis (2010) insists that the main issues under consideration included the accounting for pre-production costs on exploration and evaluation of commercial viability of minerals and two main methods that include full cost method and successful cost method arose. The methods differ in the pre-production cost capitalisation since only the costs that relate to successful discovery are capitalised under the successful efforts accounting. In this case, all pre-production costs are capitalised at the pre-production stage, but the costs are written off is the exploration project proves to be unsuccessful. For successful projects, the capitalised costs are amortised against revenues earned from the project.

Controversial areas

Successful projects method is consistent with matching and conservation accounting principle, but the inherent uncertainties in such projects may lead to unforeseen fluctuation in the income streams and account balances of the extractive entities under successful method. Although large companies may absorb losses from the unsuccessful ventures, small firms may tend to follow successful efforts accounting (David & Simon 2008).

In contrast, full cost method is popular with small exploration companies and all pre-production costs regardless of the success or failure of the project are capitalised as an asset. David & Simon (2008) conquers with Wright & Gallun (2005) that the pre-production costs should be carried forward and matched against revenues derived from successful projects and no requirement of expensing the unsuccessful projects thus an income smoothing effect results from the accounting practice. Full cost method enables smaller companies with strict debt covenants to expand and develop.

Although IFRS 16 provides the impairment assessment criteria such as unsuccessful discovery of commercial reserves and expiry of exploration rights period, it further outlines that the list is not exhaustive and full assessment need to be made. Furthermore, allowing full-cost accounting under IFRS 16 is incompatible with IASB's definition of an asset since assets are recognized in the balance sheet when it is probable that future economic benefits will be derived from use of the asset and has a cost.

Mirza, eta al. (2010) points out that IFRS 6 on exploration for and evaluation of mineral resources was developed as an interim standard so that entities in the industry could continue applying their own existing accounting practice, the standard has faced numerous limitations on its relevance and quality in furthering the accounting practice in extractive industries.

IFRS 6 does not require extractive industries to disclose their oil, gas and mineral reserves. The lack of standardised accounting practice in the industry and unsuccessful attempts in ensuring uniformity in practice is blamed on political and powerful economic connections that contributed to the standard setting process (Wiecek & Young 2010).

Critical discourse analysis

Critical discourse analysis (CDA) provides the method of explaining the standard setting process and social, political and economic contexts that can reveal the relationship between IASC and extractive industries constituents. A cross-sectional analysis of key players in the standard setting such as Exxon Mobil, PricewaterhouseCoopers (PWC), and American Petroleum Institute was conducted in order to determine their influence in the standard setting. The international accounting standard setting process can be termed as a interactive process of meaning making that enables discourse to be used to exert ‘ power, dominance and social inequality’ (Cortese, Irvine and Kaidonis, 2010). The accountancy bodies influence the priorities and outputs of the Board since international accounting firms provided monetary support to IASC. Bellandi (2012) adds that the expert views of professionals from accounting firms and extractive industries are incorporated during the ‘ due process’ that facilitates consultative stage and most of the Steering Committee members are from large accounting firms.

Views of main economic players

PricewaterhouseCoopers preferred successful efforts method as also preferred by Steering Committee, but noted special consideration be granted to small companies so that they can carry costs forward pending determination of recoverable reserves. Exxon Mobil Corporation, leading petrochemical company based in the US created a complex web of interconnectedness with players since it donated to IASB and used PwC as its auditor. Exxon Mobil supported successful efforts method, but indicated over-riding preference of US financial Accounting Standard 19 (FAS 19). The American Petroleum Institute (API) comprises of numerous members who have donated to IASB and thus the institute will develop public policies that are consistent with the expectations of the member companies. API recommended for flexible approach that is consistent with US GAAP thus allowing the industry to use both full cost and successful efforts approach. From the above analysis, it is evident that extractive industries influence the accounting standard setting process with the view of ensuring favorable regulation from IASB. IFRS 6 reinforced the status quo since it allowed flexibility in choice between the full cost method and successful efforts method thus limitiung the comparability of financial statements.

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