Extractive Industries
Financial Audit Guidelines

Supreme Audit Institution- India
Framework of Presentation

1. Extractive Industry - Challenges
2. Exploration and production activities
3. General classification of Expenditure
4. Treatment of various expenditure
5. PSEs in India – Accounting and Auditing
6. Need for Guidelines on financial audit
Extractive Industry - challenges

- uncertainties in exploration activity;
- long lead times between initial investment and first production;
- the disconnect between the amount spent to explore for, evaluate and develop an oil or gas field and its value;
- the complex risk-sharing arrangements;
- the many and varied ways in which resource-owning countries take their “share” of the economic benefits (through royalties, taxes or production and risk sharing contracts);
- and the environmental challenges
- wide variation in application of accounting and auditing principles
Accounting Guidelines : Scenario

- At present the only industry specific standard for EI is IFRS standard 6 – ‘Exploration for and Evaluation of Mineral Resources’ addresses the issue of Exploration and Evaluation (E&E)

- General Accounting Standards are applied for Development and Production and other areas of activities of EI

- EI specific financial audit guidelines are to be framed mainly based on accounting standards and practices
Lifecycle of extractive industry

Costs classification

- Pre-acquisition costs
- Acquisition of property
- Exploration and Evaluation
- Development and Production
- Support facilities and equipment
- Abandonment and surrender of properties
Stages in Accounting

- Recognition of Expenditure
- Classification of Expenditure
- Provision for future costs
- Allocation of Expenditure to cost Centre
- Depreciation, amortisation and depletion of assets
- Recognition of Revenue
Treatment of Expenditure

- **SURVEY**
- **EXPL. DRILLING**
  - **EWIP**
  - **DRY**
  - **OIL/GAS BEARING**
- **DEVELOPMENT (INCL. DEV. DRILLING)**
  - **DWIP**
  - **PRODUCING ASSETS**
  - **DEPLETION BY UNIT OF PRODUCTION METHOD**
- **PRODUCTION EXP./OH AND R&D EXP.**
- **PROFIT & LOSS ACCOUNT**
Pre-Acquisition Cost

- Pre-acquisition cost *viz.* data collection, analysis, *etc.* not usually associated with any specific mineral are charged to profit and loss account or capitalised depending on the policy of the Enterprise.

Acquisition of Property

- Costs includes cost incurred in acquiring the right to explore, drill and produce oil / mineral.

Exploration and Evaluation

- Geological Evaluation / appraisal - determining the technical feasibility and commercial viability of mineral deposits.

These cost are generally capitalised as Exploratory-WIP (EWIP) which is transferred to Assets if exploration is successful or amortised if unsuccessful.
Common Accounting approaches

- Successful Efforts Method (SEM) - only those assets that lead directly to discovery, acquisition and development are capitalised.

- Full Cost Method (FCM) - All costs incurred in acquiring mineral interest, annual fee, exploration and development are accumulated in cost values.

- Generally SEM is adopted. However, wide variations exist in the treatment of various items of expenditure and its reclassification.

- Accounting for E&E expenditure is a critical element in ensuring that the financial statements fairly represent their activities/position.
Exploration and Evaluation - Reclassification

- E & E Assets- shall no longer be classified as such when technical feasibility & commercial viability of extracting mineral resources are demonstrable

- Classification of expenditure forms the basis of presentation and subsequent measurement of assets and has its impact over a long period

- Nature of expenditure to be classified under E&E, production and stage at which acquisition, E&E and production assets are to be re-classified into development / producing assets

- Stage of projects need to be monitored/checked to ensure accounting policies are applied appropriately

- E & E Assets – can be tangible or intangible hence presentation requirements in the accounts as per respective Accounting Standards for Fixed Assets and Intangible Assets.
Production

- After commencement of commercial extractions of Oil & Gas and Minerals from reserves / deposits all operating expenditure on production are generally charged/expensed.
- Depreciation on producing properties charged based on unit of production method / depletion.

Decommissioning / Abandonment

- Legal, contractual and / or constructive obligations to meet the costs
  - decommissioning and dismantling assets;
  - restoring the site environmentally to sound conditions;
  - closure of mines, rehabilitation, afforestation
- Provision for decommissioning – whether at current / discounted value
Depreciation, Depletion, Amortisation

**SURVEY** → **DRILLING** → **FACILITIES & INSTALLATIONS** → **OTHERS**

- **EQUIPMENT**
- **EQUIPMENT**
- **EQUIPMENT**

- **USED FOR**
  - **EXPL. DRILL.**
- **USED FOR**
  - **DEV. DRILL**

- **DEP.**
- **DEP.**
- **DEP.**
- **DEP.**

- **CHARGED TO**
  - **P/LA/C**
- **ADDED TO**
  - **EXPL. DRILLING**
- **ADDED TO**
  - **DEV. DRILLING**
- **ADDED TO**
  - **PRODUCING PROPERTIES**
- **CHARGED TO**
  - **P/LA/C.**
Impairment of assets

- Identification of cash generating units for allocating E&E assets to cash generating units for impairment
- Assets need to be assessed for impairment and any impairment loss recognised before reclassification of E&E assets
- E & E assets to be assessed for impairment when carrying amount of E & E asset exceed its recoverable amount:

Revenue Recognition

- Timing of transfer of risks and ownership in order to determine when to recognize revenue
- Accounting policy for revenue and valuation of closing stock
Interest in Joint ventures

- Determining whether an arrangement is a Joint Venture or joint arrangement
  - Joint venture (structured through a separate vehicle)
    - will account for its involvement in the joint venture using the equity method investments in Associates and Joint Ventures
  - Joint operations (not structured as a separate vehicle)
    - recognizes its own assets, liabilities and transactions, including its share of those incurred jointly

- Need for disclosure of entity’s interest, nature of interest and disclosure of method of consolidation, whether equity or proportionate consolidation
Reserves Reporting

- Measuring and reassuring process
  - Proved and developed Reserves
  - Proved and undeveloped Reserves
  - Proved and probable reserves

- Disclosure of the process for preparation/ or audit of the reserves report

- Presentation style and measurement methodologies
  - Depend on measurement by technical group, management assessment, basic assumptions, changes in the reserves estimates and its impact in financial position and operation.

- Change in measurement and its adjustment of impact in accounts, prospective /retrospective
PSEs in India – Accounting in EI

- PSE in EI sector in India follow Indian Accounting Standard - IND-AS 106 and other IND-AS and guidance note of ICAI on accounting aspects
- Pre acquisition costs are expensed /charged off
- SEM is used in accounting for E&E assets
- Depreciation on exploration/development stage is capitalised –as EWIP/Assets under development and then transferred to producing properties
- Producing properties are amortised/ depleted on the basis of reserves estimates and units of production
- Abandonment costs are provided for and adjusted as and when there is change in reserves estimate
- Different valuation methods and assumptions are followed by different PSEs.
- Disclosure of Accounting policies vary
- For reserves reporting auditors usually rely on the certificate of the technical group and the Management, however, basic assumptions, principles, consistency etc. are checked
- Revenue to National Government - Royalty, Dividend share in PSE, Corporate taxes, Cess etc.
PSEs in India – Audit

- Statutory audit is conducted by the CAs appointed by the CAG
- SAI India conducts supplementary audit of PSEs
- IND-AS 106 ‘Exploration for and Evaluation of Mineral Resources’ is the equivalent Indian Accounting Standard for IFRS 6 covers Exploration and Evaluation.
- Development and Production, Segment reporting, componentisation of assets, capitalisation of borrowing costs, foreign exchange fluctuation, business combinations, disclosure and presentation requirements etc. – treatment of these items are governed by other relevant IND-AS
- ICAI Guidance Note on auditing is followed by auditors for auditing of E&E, development and production accounting of PSEs.
- SAI India has Auditing Standards and Manual on Financial Attest Audit developed in consonance with the INTOSAI Auditing Standards
Conclusion

Need for Financial Guidelines in auditing of Extractive Industries

- Wide variation exits in application of accounting and auditing principles
- Disclosure on various aspects also vary widely within EI, having an impact on the presentation of financial statements and on operating results over a long period.
- Hence it is important to frame guidelines for auditing of extractive industries to be followed by auditors.
- Common financial reporting language
  - enable users to have comparable information
  - Achieve greater global transparency and consistency
Thank you