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evidence from the extractive industries**

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Abstract

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Keywords

process, setting, standard, accounting, industries, international, extractive, politicisation, evidence

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Politicisation of the international accounting standard setting process: evidence from the extractive industries

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Purpose - *The purpose of this paper is to provide a detailed example of the way in which extractive industries constituents participated in the setting of the international accounting standard for the extractive industries, IFRS 6 – Exploration for and Evaluation of Mineral Resources.*

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Keywords: *Extractive industries, accounting standard setting, accounting regulation, politicisation, lobby groups.*

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Introduction

The contextual nature of accounting standard setting processes is well-established in the literature, with important studies from Rappaport (1977), Solomons (1978, 1983), and Zeff (1978) pioneering notions of the politicisation of accounting standards and observing the influence of “outside forces” (Zeff, 1978, p.56) over the standard setting process.

In a recent study, Nichols (2012) asks “Has international oil and gas accounting been politicized?”, and considers International Accounting Standards Board’s recent efforts to regulate oil and gas accounting via its extractive industries project and the Financial Accounting Standards Board’s involvement with this project. This paper addresses Nichols’ (2012) question by providing a detailed example of the way in which industry constituents participated in the setting of the international extractive industries accounting standard, International Financial Reporting Standard (IFRS) 6 – Exploration for and Evaluation of Mineral Resources.

IFRS 6 was issued in December 2004 as the culmination of a six-year project, initiated by the International Accounting Standards Committee (IASC) and later continued by the International Accounting Standards Board (IASB). The standard was to address accounting and disclosure issues and narrow the alternative accounting practices that are prevalent across the oil and gas and mining sectors. The IASC’s project came as a belated response to frequent calls for the standardization of accounting and disclosure practices, which were fuelled by the distinctive characteristics and economic significance of the extractive industries, and the increasing need to compare financial statements across international borders without the variable effects of applying numerous industry accepted accounting practices (Deloitte Touche Tohmatsu, 2001; Luther, 1996; Wise & Spear, 2000).

When issued, IFRS 6 failed to address the key issue responsible for much of the disparity in extractive industries reporting, which concerns the methods used to account for pre-production costs. These costs, also known as exploration and evaluation costs, comprise some of the most significant expenditures incurred by extractive industries companies, with costs often exceeding hundreds of millions of dollars annually. ExxonMobil for example, as the world’s largest petroleum company, spent US\$27 billion on exploration in 2009 (ExxonMobil Corporation, 2009). Exploration budgets are also significant even for the smaller companies, with Anadarko Petroleum Corporation, for example, spending US\$1.3 billion on exploration efforts during 2008 (Anadarko Petroleum Corporation, 2009). Given the millions of dollars that companies spend on pre-production activities, the way these costs are allocated in the accounting process is important and, over time, different industry practices have developed that produce significantly different accounting results (International Accounting Standards Committee, 2000; Katz, 1985; Nichols, 2012; Van Riper, 1994).

The two main practices that are used to account for pre-production costs are known as the successful efforts method and the full cost method. While both methods are based on the historical cost concept of accounting, the key difference is the means by which successful and unsuccessful exploration ventures are treated in the accounts. The successful efforts method stipulates that costs relating to exploration and evaluation activities may be capitalised only if they relate to the successful discovery of petroleum or mineral reserves, with all costs relating to unsuccessful ventures to be expensed as incurred. The full cost method, however, permits all exploration and evaluation costs, whether related to successful or unsuccessful ventures, to be capitalised and written off against revenues from successful projects (Amernic, 1979; Flory & Grossman, 1978; ISAC 2000).

Although the successful efforts method is argued to be consistent with the accounting principles of matching and conservatism, the inherent uncertainty associated with exploration activities means that the income streams and asset balances of entities reporting under the successful efforts method can fluctuate significantly (Editorial, 1986; Frazier & Ingersoll, 1986). As a result, the successful efforts method is typically avoided by smaller companies and instead adopted by large entities that can afford to absorb the losses from unsuccessful exploration efforts (Frazier & Ingersoll, 1986). Smaller companies have historically favoured the full cost method (Amernic, 1979; Flory & Grossman, 1978; Frazier & Ingersoll, 1986). This is because the capitalization of both successful and unsuccessful ventures creates healthier asset balances and, by not having to write off unsuccessful exploration efforts, expenses are reduced and income is smoothed (Flory & Grossman, 1978; Ingersoll, 1986; IASC 2000).

The effect of IFRS 6, despite the stated purpose of the IASC's extractive industries project, was that it codified rather than narrowed existing practice. It did this by granting extractive industries companies an exemption from the provisions of other standards, such as IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, which would have required companies to use accounting methods consistent with the IASB's Conceptual Framework definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses (IASB 2004b). If the provisions of the Framework, and thereby IAS 8, were followed, companies would have been required to follow the successful efforts method thus eliminating the full cost accounting practices.

As noted, in her recent paper Nichols (2012, p.22) considers whether this outcome of the extractive industries project was a consequence of the "political clout" of industry constituents. Nichols (2012) also reviews the historical controversy surrounding these methods in the United States (US) oil and gas sector and likens this to the efforts of the international accounting standard setting to regulate accounting practice for the industry (Van Riper, 1994). In the US case, it was arguably political pressure from oil and gas industry constituents that contributed to the Financial Accounting Standards Board's failure to eliminate full cost accounting (Flory & Grossman, 1978; Frazier & Ingersoll, 1986; Ingersoll, 1986; Solomons, 1978; Van Riper, 1994; Zeff, 1978) and both the full cost and the successful efforts methods are used by extractive industries entities to this day. When the IASC embarked on its extractive industries project in 1998, it reopened this issue at the international level and, once again, the successful efforts and full cost methods were under the spotlight and, once again, the standard setter failed to standardise accounting practices (IASC 2000).

With the potential for politicisation of accounting standard setting processes well-established (Fogarty, et al., 1994; Hope & Gray, 1982; Rappaport, 1977; Solomons, 1983; Walker, 1987; Walker & Robinson, 1993; Zeff, 1978, 2002), it is important to closely examine the international accounting standard setting process for the extractive industries, paying particular attention to the key players involved and the procedures by which the standard was developed. The following sections outline the due process procedures followed by the IASC/IASB when setting an international accounting standard, describe the key constituents involved in the process, and map the intricacies of one specific network of these constituents to provide support for the politicisation argument.

The standard setting process

The international accounting standard setting process for the extractive industries formally commenced in 1998 when the IASC added the extractive industries project to its agenda (IASC 1998). To lead the project, a Steering Committee was formed and the

Extractive Industries Issues Paper (hereafter the Issues Paper) was published in November 2000 and made available for public comment until June 2001.

The methods of accounting for pre-production activities were considered in Chapter Four of the Issues Paper, which contained a tentative view from the Steering Committee that accounting alternatives be removed and all companies required to report according to the successful efforts method. Constituents were asked to indicate their preferred method and comment letters were received from fifty-two respondents, many of these being multinational extractive industries companies and associated lobby groups. Of the thirty-seven respondents who commented specifically on the successful efforts versus full cost issue, twenty-nine (seventy-eight percent) explicitly agreed with the treatment proposed by the Steering Committee. Interestingly, most of these supporters were large extractive industries enterprises that were already using the successful efforts method or by professional accounting firms that were representing the interests of their clients, which are these same large enterprises. While in the minority, some respondents expressed fervent opposition to the proposed elimination of the full cost method, the most significant of these opponents being the American Petroleum Institute and the UK Oil Industry Accounting Committee, the world's largest extractive industry lobby groups, who argued that both the successful efforts and full cost methods should continue to be permitted under IFRS.

Before address comment letters specifically, the institutional structure of the international accounting standard setting body should be highlighted so that the contextual relevance of the relationships between constituents and the standard setter are understood. Prior restructure of the IASC in 2001, funding to support the standard setting process came from three main sources: fees paid by Board members and by the International Federation of Accountants, profits made on IASC publications, and, importantly, voluntary contributions from companies and other organisations with an interest in the work of the IASC (IASC, 1999). As part of the restructure, the IASC Foundation (IASCF) was formed and the IASB was to be supported primarily by private contributions of chartered accounting firms and international business enterprises (IASCF, 2001). In order to secure a steady stream of funding, the IASCF established an “underwriter” class of supporter comprising major international financial and business organisations (IASCF, 2001, p.3). Underwriting companies were asked to make five-year pledges of monetary support to the IASB ranging from £100,000 and £200,000 per year. In addition, other “supporters” make annual, undisclosed contributions to the IASB (IASCF, 2001). At the inception of the restructured IASB, the (then) “Big 5” chartered accounting firms each pledged £1,000,000 per annum, which comprised approximately one third of the IASB's estimated operating budget (IASCF, 2001).

Significantly, many of the financial supporters of the IASB's standard setting programs also stand to gain, or lose, from the standards that the IASB promulgates, raising concerns over the potential for a dependency relationship between the IASB and its benefactors (Brown, 2004, 2006). In 2004 when the IFRS for the extractive industries was finally issued, the IASC Foundation reported that it received contributions totalling almost £10,000,000 from 186 corporations, associations, and other institutions, including extractive industries companies such as the Anglo American Group, BHP Billiton, Rio Tinto, (then) Conoco Inc, Exxon Mobil, and Petrochina (IASCF 2005).

To outline the intricacies of the connections between constituents of the standard setting process and the IASB, the contribution of three constituents is presented in the following sections: international accounting firm KPMG, independent oil and gas exploration company Kerr McGee, and UK-based petroleum industry lobby group the Oil Industry Accounting Committee (OIAC). It should be noted that this cross-section of players is presented as just one example of the several, similar networks of constituents that

permeated the standard setting process for the extractive industries (for other examples see Cortese et al. 2007, 2010).

IASC/IASB and KPMG

The five accounting firms already identified as major contributors to the IASC/IASB were PwC, KPMG, Ernst & Young, Deloitte Touche Tohmatsu, and Arthur Andersen. These accounting firms have traditionally provided important resources to the IASC/IASB in the form of staff, technical expertise, and members for many of the IASC/IASB's committees. As well as providing financial, personnel, and technical support, the chartered accounting firms serve an important liaison function between the IASC/IASB and their clients. Georgiou (2004) noted that a considerable number of companies lobby the IASB through their external auditor thus requiring extensive consultation between auditor and client in order to ensure that client interests are accurately represented.

As noted, the extractive industries project was led by a Steering Committee. The Chairman of this committee was Ken Spencer, a partner of KPMG in Australia and also former Chairman of the Australian Accounting Standards Board. Another Committee member, John A. Gordon, was seconded to the project from the Canadian office of KPMG (IASB 2000). In its response to the Issues Paper, KPMG argued that there is no "right or wrong" (KPMG, 2001, p.5) answer to the debate over successful efforts versus full cost accounting, and that the method of accounting chosen should be that which most accurately reflects the results of management decisions (KPMG, 2001). Although KPMG indicated its preference for a method consistent with the successful efforts concept, it did recognise the relevance of the full cost method for a "significant body of companies" and the smaller, independent companies in particular (KPMG, 2001, p.5):

KPMG considers that there is no right or wrong answer to the debate about which method of accounting is preferable. The arguments made in favour of each are that they properly reflect the way in which particular businesses are managed and so present most appropriately the results of management decisions. It is KPMG's experience that this is the case. The way that decisions are made on prospecting and exploration activity by major companies and by the smaller "independent" sector can be very different.

We encourage the IASB to address the issue by first considering the extent to which the Framework provides an appropriate basis for accounting for the extractive industries, particularly the application of the Framework definition of an asset and the recognition criteria to prospecting, exploration and development activities.

In their comment letter, KPMG also suggested a number of possible ways forward for the IASB in this matter. Interestingly, their first suggestion was that the standard setter "codify current practice" so that the various accounting treatments could be retained (KPMG, 2001, p.5).¹

IASC/IASB, KPMG and Kerr-McGee

Kerr-McGee, acquired by Anadarko Petroleum Corporation in 2006, was one of the world's largest independent oil and gas companies (Kerr-McGee, 2006). Immediately before

¹ Given the presence of the Canadian KPMG partner on the Steering Committee, it is also worth noting that the Canadian Institute of Chartered Accountants provided a submission in response to the Issues Paper in which it argued that the mining industry, an important segment of the Canadian economy, would be adversely affected by a move to successful efforts accounting because of the prevalence of the full cost method among the junior mining companies (Canadian Institute of Chartered Accountants, 2001).

it was acquired, Kerr McGee spent US\$407 million on exploration and evaluation activities, which were accounted for using the full cost method (Kerr-McGee, 2005). In 2006 when the acquisition took place, Anadarko also used the full cost method to account for its pre-production activities (Anadarko Petroleum Corporation, 2006). During 2007, however, the company switched its method of accounting for oil and gas exploration and development activities to the successful efforts method (Anadarko Petroleum Corporation, 2007). This change in accounting policy required an adjustment to the financial statements for the 2006 reporting year, resulting in a downward restatement of income by US\$322 million and a decrease of US\$2,265 million in reported retained earnings, which represented twenty-five percent of the total retained earnings of the company (Anadarko Petroleum Corporation, 2007). Interestingly, the auditor for Anadarko is KPMG.

Kerr-McGee participated passively in the international accounting standard setting process however their comment letter in response to the Issues Paper was short but telling: “we wish formally to note our support for the representations made by the Oil Industry Accounting Committee in response to the...Issues Paper”. That Kerr-McGee was content to leave the ‘heavy lifting’ to the OIAC underscores the important role played by lobby groups in the standard setting process.

IASC/IASB, KPMG, Kerr-McGee, and the OIAC

Like the American Petroleum Institute in the US, the OIAC is the UK-based lobby group for the extractive industries. It was established in 1984 in order to represent the oil and gas industry in various accounting forums and to assist the industry with matters relating accounting standards interpretation and application (OIAC 2011). The Committee itself has just fifteen members but represents the interests of all companies engaged in the upstream sector of the oil and gas industry. All of the Big 4 accounting firms are members of the Committee as well as representatives from major corporations such as BP and Shell and smaller independent companies including Premier Oil and Osprey Oil & Gas Ltd (OIAC 2011).

In a comment letter remarkably similar to that submitted by KPMG (see excerpt above), the OIAC also considered there to be no “right or wrong” (OIAC 2001, p.6) answer to the debate over successful efforts versus full cost accounting, and that the method chosen should be that which most accurately reflects the results of management decisions (OIAC 2001). The OIAC did, however, stress the importance of retaining both methods, arguing that:

OIAC is of the view that it would be wrong to restrict companies to using one method of allocating costs. The arguments made in favour of each are that they properly reflect the way in which particular businesses are managed and so present most appropriately the results of management decisions. It is OIAC’s experience that this is very much the case. The way that decisions are made on prospecting and exploration activity by major corporations and by the smaller “independent” sector can be very different.

The majority of UK listed upstream companies account under the full cost method. In practice OIAC considers that the choice of selecting either successful efforts or full cost...enables companies to properly reflect their particular decision taking process in their financial statements, and therefore should be retained (OIAC 2001, p.2).

The similarity of the statements made by OIAC and KPMG, particularly in the initial paragraphs, which are almost identical, suggests that a significant consultation process had taken place between this lobby group and KPMG in order to represent consistent views to the IASB.

The connectedness of these three constituents, with each other and with the IASB, is discussed in the following section in order to strengthen the case for the politicisation of the international accounting standard setting process for the extractive industries.

Influencing the “new” accounting standard

It is important that the involvement of the three constituents, just one example of several similar networks, be critiqued in order to make sense of the outcome of the international accounting standard setting process, IFRS 6. When the standard setting process commenced in 1998, the Steering Committee noted that an explicit aim of the project would be to identify and address the diversity of accounting practices used by extractive industries companies (IASC 2000). With the publication of the Issues Paper, the Steering Committee undertook to review public responses and use these to develop an Exposure Draft that would also be made available for public comment (IASC 2000). The comments received in respect of the Exposure Draft would be reviewed, after which a final standard would be produced for consideration by the restructured IASC Board.

In outlining its anticipated program, however, the IASC incorporated a caveat that it was in the midst of a restructure and that the new IASC Board would have to “have to decide its own agenda and priorities” (IASC 2000, p.5). Following the restructure, the IASB put the extractive industries project on hold, announcing in July 2001 that it would restart the project only when agenda time permitted. By September 2002, the IASB had decided that it was not feasible to complete a comprehensive project in time for adoption by entities in 2005. In place of a comprehensive accounting standard, the IASB issued Exposure Draft 6 Exploration for and Evaluation of Mineral Resources (ED 6) in January 2004 (IASCF 2004). This exposure draft outlined only limited changes to existing practice because it was intended that a “more complete consideration of the accounting issues” would be forthcoming and therefore the “interim” accounting standard, IFRS 6, should not require major changes that would cause “unnecessary disruption” for reporting entities (IASCF Heaphy, 2004; 2004, p.9). In its basis for conclusions, the IASB granted extractive industries entities an exemption from meeting some of the requirements of other IFRSs and the IASB Conceptual Framework, permitting entities to continue to use their existing accounting policies:

The [draft] IFRS proposed to exempt entities from some requirements of other IFRSs and the IASB Framework. Instead of requiring entities engaged in the exploration for and evaluation of mineral resources to consider the various sources of authoritative requirements and guidance in developing an accounting policy for such activities, the [draft] IFRS permits those entities the alternative of continuing their existing accounting treatment in specified circumstances. In particular, paragraph 4 provides that an entity may continue to account for exploration and evaluation assets in accordance with the accounting policies applied in its most recent annual financial statements (IASCF 2004). In sum, the proposed standard would permit the use of both the successful efforts and full cost methods to be used by extractive industries entities when accounting for their pre-production activities. Unsurprisingly, there was little opposition to these proposals and the provisions of ED 6 were eventually incorporated into IFRS 6 on 9 December 2004 (IASB 2004a).

This decision by the IASB is consistent with the recommendations put forward by KPMG in their response to the Issues Paper, which suggested that current practice be “codified” (KPMG, 2001, p.5). It is also consistent with the representations of the OIAC, which argued for the retention of the full cost and successful efforts methods. This certainly adds to arguments for the politicisation of the international accounting standard setting process for the extractive industries. Recall that each of the (now) Big 4 accounting firms provide £1,000,000 per annum in funding to the IASB (IASCF 2001). KPMG is, of course,

one of these firms. The Steering Committee that led the extractive industries project was chaired by a KPMG partner and another KPMG partner from the Canadian arm of the firm also served on the Committee. The OIAC's membership also includes representation from KPMG, as well as each of the other big accounting firms. The OIAC represents the views of hundreds of oil and gas companies throughout the UK and the rest of the world, which gives it enormous power as a lobbying force. Also significant is the fact that the submissions and recommendations put forward to the extractive industries Steering Committee by KPMG and OIAC were, in parts, identical. Further, the final accounting standard issued by the IASB was consistent with the KPMG and OIAC recommendations. While this paper analyses the connections and representations of just three key players, similar arguments and connectedness exist between several of the respondents (see, for example, Cortese et al. 2007, 2010). The end result is that, significantly, one of the world's most important economic sectors is yet to have its accounting practices adequately regulated by the International Accounting Standards Board (IASB) (Cortese et al. 2010; Nichols, 2012).

Conclusion Summary

This paper has used an example of three key players involved in the international accounting standard setting process for the extractive industries to further the argument for politicisation of accounting standard setting. The analysis of submissions made by KPMG, Kerr McGee, and the OIAC, and their interactions with the IASB and each other, has highlighted the web of relationships that is characteristic of standard setting process and that arguably contributed to the final outcome, IFRS 6, being a codification of the existing practices. This places in doubt the proclaimed transparency and independence of the IASB as a standard setting institution, and although it is widely acknowledged that the accounting standard setting process is political, this research highlights the source, nature and effect of this politicisation.

While the focus of this study has been on the IASB, on the development of one accounting standard, on the responses made to one Issues Paper, and on only a cross-section only of those responses, it does present opportunities for further research. For example other issues related to the accounting for extractive operations could be considered such as practices used to account for removal and restoration expenses or the agenda setting processes of the IASB. A useful supplement to this study would also be an analysis from the perspective of an 'insider' who is privy to the machinations of the standard setter.

The potential for the IASB to be 'captured' by those companies that are intended to be bound by the standards it issues is of particular concern given that the IASB claims to be an independent organization acting in the public interest seeking worldwide diffusion of its accounting standards that will, ultimately, affect global capital markets.

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