



# New on the Horizon: Extractive Activities

September 2009

# Foreword

Accounting for the activities of entities involved in the extraction of mineral resources has provided many difficulties over the years and has led to a variety of approaches being developed by companies. This in turn led a number of countries, notably Australia, Canada, Norway, South Africa, the UK and the U.S., to issue at least some industry guidance to drive a consistency of approach within their countries.

With the advent of the widespread use of International Financial Reporting Standards (IFRSs), it was recognised that extractive activities was an area in which there was little guidance. Indeed, until 2004 extractive activities were scoped out of most relevant standards but with no explicit guidance being provided.

A project on extractive activities was initiated by the predecessor body of the International Accounting Standards Board (IASB), the International Accounting Standards Committee (IASC), as long ago as 1998. The IASC published an Issues Paper *Extractive Industries* in November 2000.

In July 2001 the IASB announced that it would restart the project when agenda time permitted. In September 2002 the Board decided it was not feasible to complete a comprehensive project addressing the accounting for extractive activities in time for the many entities that were transitioning to IFRSs in 2005. However, the IASB agreed on a limited-scope project to provide guidance on the treatment of exploration and evaluation costs for entities applying IFRSs in 2005; consequently, in December 2004 the IASB released IFRS 6 *Exploration for and Evaluation of Mineral Resources* as an interim measure pending completion of the comprehensive project.

The research stage of the comprehensive project commenced in April 2004, after the IASB and liaison national standard-setters agreed on a research project plan. At the IASB's request, a project team comprising representatives from the national standard-setters of Australia, Canada, Norway and South Africa commenced work on the research project.

Progress however has been slow. After five years, last month the IASB issued on its Web site ([www.iasb.org](http://www.iasb.org)) a working draft of the project team's discussion paper (DP). This draft DP represents the preliminary views of the project team and not necessarily those of the IASB. The IASB states that it intends to issue a final version of the DP for comment during the first quarter of 2010.

Although unsurprisingly the IASB has other priorities given the economic events of the last 18 months, we believe that it is important that an accounting standard is issued as soon as possible. Our surveys *The Application of IFRS: Oil and Gas* published in October 2008, and *The Application of IFRS: Mining* published in September 2009, both show that there are significant variations in practice that need to be addressed.

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## About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

We would like to acknowledge the efforts of the principal authors of this publication. Those authors include Julie Santoro and Nicole Perry of the KPMG International Standards Group, and Jimmy Daboo of KPMG in the UK.

### Content

This *New on the Horizon* considers the requirements of the draft DP *Extractive Activities*. It includes a discussion of the key elements of the proposals and highlights areas that may result in a change of practice.

Further analysis and interpretation will be needed in order for an entity to consider the potential impact of this draft DP in light of its own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change.

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## Overview of proposals



- A single standard would be developed covering both the mining and oil and gas industries.
- For reserves and resources measurement and disclosure, the Committee for Mineral Reserves International Reporting Standards definitions would be used for mining, and the Petroleum Resource Management System definitions would be used for oil and gas.
- An asset would be recognised once legal rights to explore a defined area for a mineral or oil and gas deposit are acquired.
- All costs incurred in prospecting, exploration and evaluation activities subsequent to the acquisition of legal rights would be capitalised.
- Upon initial recognition, the unit of account would be the area covered by the “licence to explore”. As additional work is performed in an area, the unit of account would contract so that the cost is allocated down to individual sub-areas over time. It is envisaged that the unit of account would be no larger than a single area (field or mine) by the development phase.
- Assets would be measured on a historical cost basis, with extensive disclosure to assist users of the financial statements in assessing the value of an entity’s mineral or oil and gas assets.
- Prior to development, assets would be tested for impairment only when evidence is available to suggest that the carrying amount of the asset is unlikely to be recovered in full. During the development and production phases assets would be tested for impairment in accordance with IAS 36 *Impairment of Assets*.
- A single disclosure approach would apply to both mining and oil and gas extractive activities. The disclosures would include reserve quantities, current value measurement (if the asset is measured at historical cost), fair value measurement (if the asset is measured at fair value), production revenues and costs.
- The IASB has not invited comments on the proposals. A request for comments is expected to be issued by the IASB in the first quarter of 2010.

# 1. Scope and approach

The scope of the draft DP is restricted to extractive (upstream) activities for minerals, oil and natural gas, i.e., prospecting, exploration, evaluation, development and production. The scope includes non-conventional oil and gas sources, such as oil sands and tar sands.

The scope is narrower than the scope of current IFRS 6, which includes “other similar non-regenerative resources”. Therefore, for example, the extraction of minerals from seawater is within the scope of IFRS 6, but excluded from the scope of the draft DP.

## Observations

Entities should consider whether the scope is suitably broad to cover existing and anticipated activities that have similar risks within the extractive activities arena, including emerging sources of oil and gas, and new technologies, particularly green technologies. For example, the activities involved in finding and developing “sinks” that can be used for CO<sub>2</sub> sequestration and storage may well have some similarities.

The draft DP proposes a single approach for both the mining, and oil and gas industries. In reaching this proposal the project team concluded that the activities and the risks and rewards of those activities are sufficiently similar to allow a single accounting model to be applied.

## Observations

While some similarities exist between mining and oil and gas activities, significant differences exist between operations and processes. For example, mining companies need to consider stripping ratios when operating, whereas an offshore oil operator may be more concerned with the unit-of-production calculation and average flow rates. A single accounting approach needs to be flexible enough to allow entities to apply principles to these transactions and achieve a sensible accounting approach, taking into account differences between the industries.

By proposing a single model, the project team has avoided the need to consider the classification of certain non-conventional sources, such as oil sands, since the same accounting and disclosure requirements would be applied to both the mining and oil and gas industries. The advantage of this approach is that it eliminates an entity having different disclosures for different sources of oil and gas, which currently is an issue for entities in some jurisdictions. However, a potential disadvantage is the need to fit all activities within a single disclosure model (see 5. *Disclosure*).

It will be important for the final standard to deal with issues that apply in only one of the two industries, such as the treatment of stripping costs in open pit mining, and to ensure that it does not result inadvertently in the application of a principle that is appropriate for one industry but not the other.

## 2. Definitions of reserves and resources

The clarity of the definitions used to classify and measure reserves and resources is key to ensuring consistency and comparability amongst entities. For entities involved in extractive activities, measures of reserves and resources are vital business information; and in our experience, for “exploration and production” companies changes in reserves and resources are considered by some users to be a better indicator of performance than profit or other financial statement measures. This is because entities can spend large amounts exploring over a long period of time; however, once production commences, the return usually far exceeds the costs incurred, and the revenue stream lasts for the life of the mine or field, which can be over 40 years.

In addition, reserves and resources estimates have a significant impact on amounts recognised in the financial statements, including depreciation, depletion and amortisation (DD&A) calculations, impairment calculations, and life-of-mine or life-of-field estimates used in decommissioning calculations.

The project team considered whether existing definitions developed by industry bodies are broadly understood and accepted by users of financial statements, as well as by the entities themselves. The project team also considered alternative definitions, from sources such as regulators, to determine if these were more appropriate to use for the purposes of financial reporting. The draft DP notes that the definitions of reserves and resources currently being applied by financial statement preparers are varied, and recommends that a single definition of reserves and resources be used to cover both the mining and oil and gas industries.

As there is no existing single definition, the DP discusses two potential solutions: (1) ask the IASB to develop a new single and consistent definition; or (2) use the definitions from the Committee for Mineral Reserves International Reporting Standards (CRIRSCO) and the Petroleum Resource Management System (PRMS), which broadly are acknowledged as the most common definitions used currently and are considered to have sufficient similarities to be used in a single standard approach.

The project team concludes that the CRIRSCO and PRMS definitions are the most appropriate existing definitions. The draft DP notes that there are a number of similarities between the definitions that would allow them to be used to produce comparable accounting outcomes by mining and oil and gas entities.

### Observations

Both the CRIRSCO and PRMS definitions and frameworks were developed for use by mining and oil and gas industry participants to provide consistent measurement for a wide variety of purposes. While neither was developed primarily for accounting purposes, the needs of the accounting profession were considered in their development.

In summary, there are at least two key considerations in assessing the appropriateness of the proposal. Firstly, are the reserve and resource measures that result from these definitions sufficiently compatible with their use in developing accounting estimates? Secondly, are the reserve and resource measures useful for disclosure purposes in the context of a general purpose set of financial statements? In both cases we believe that the answer is “yes”.

In our view, the IASB should not be expected to have the knowledge required to develop a new definition of reserves and resources, and industry definitions currently are widely understood by both preparers and users of financial statements; therefore the proposal appears logical and we believe that the development of definitions purely for accounting purposes should only be a last resort. Additionally, if industry-developed definitions are used, then the definitions can change as technology changes and extraction methods evolve in a more efficient manner than if the definition were being managed by the IASB.

For some entities the use of the CRIRSCO and PRMS definitions will closely align to the reserves and resources definitions used for management purposes. However, entities that are using existing definitions of the U.S. Securities and Exchange Commission are likely to see differences in reserves and resources reported under the proposed definitions.

While there are many similarities between the CRIRSCO and PRMS definitions, there are some significant differences, such as in respect of resource classifications. Constituents will need to consider whether the advantages of using existing definitions outweigh the potential disadvantages of different approaches.





### 3. Asset recognition

The identification and recognition of an asset is one of the most difficult issues to address in accounting for extractive activities. The timing of recognition is complicated by the risks of exploration, long lead times for projects, and difficulties in assessing when commercial and technical feasibility have been reached.

Entities applying IFRSs have adopted a number of approaches to address this issue. Oil and gas entities typically use a successful efforts or a (modified) full cost approach to recognising and measuring exploration and evaluation assets. Mining entities typically apply an area of interest approach. However, while these labels feature heavily in accounting policy statements, these methods are not mentioned in IFRSs, but have evolved as a practical approach to communicating broadly how entities account for exploration and evaluation activities. There can be considerable differences in what entities mean when they use these terms, and in our experience, the individual application of these methods can vary significantly in practice.

One element of the recognition criteria for an asset that has been difficult to demonstrate is the probability of future economic benefits, particularly for entities with exploration and evaluation assets. Currently IFRS 6 allows entities to capitalise costs incurred during exploration and evaluation, despite the entity not being able to establish that there are probable future economic benefits from those activities while determining whether reserves exist.

The draft DP identifies that extractive activities generally involve the acquisition of legal rights in the early stages. The project team proposes that an asset be recognised upon the acquisition of the legal rights, and that subsequent expenditure be capitalised because it results in information that enhances the value of the underlying asset, i.e., the right to explore. This means that even the costs incurred in, for example, unsuccessful drilling would be capitalised. However, unsuccessful drilling might trigger an impairment test (see 4. *Measurement*).

Under the proposals all expenditure would be capitalised as a single asset, the right to explore for and exploit minerals in a particular geographical area. This includes expenditure in the development and production phases because the draft DP views all of these activities as an improvement or enhancement of the underlying legal rights.

A model to determine the unit of account is proposed based on geographical boundaries. Upon initial recognition of the legal rights to an area, the entire area would be the unit of account. As exploration progresses and more detailed information is available, the unit of account would contract, and would be reassessed to reflect smaller and more identifiable sub-areas. The project team notes that by the development phase the unit of account would be no larger than a single area, or a group of contiguous areas that generate largely independent cash flows.

Plant and equipment assets would be recognised as separate assets when (1) they generate largely independent cash flows; (2) they are physically and commercially separable, i.e., moving such assets to other operations is realistic and could be justified economically; or (3) their useful lives are different from the legal rights.

The unit of account has important implications for impairment testing (see 4. *Measurement*).

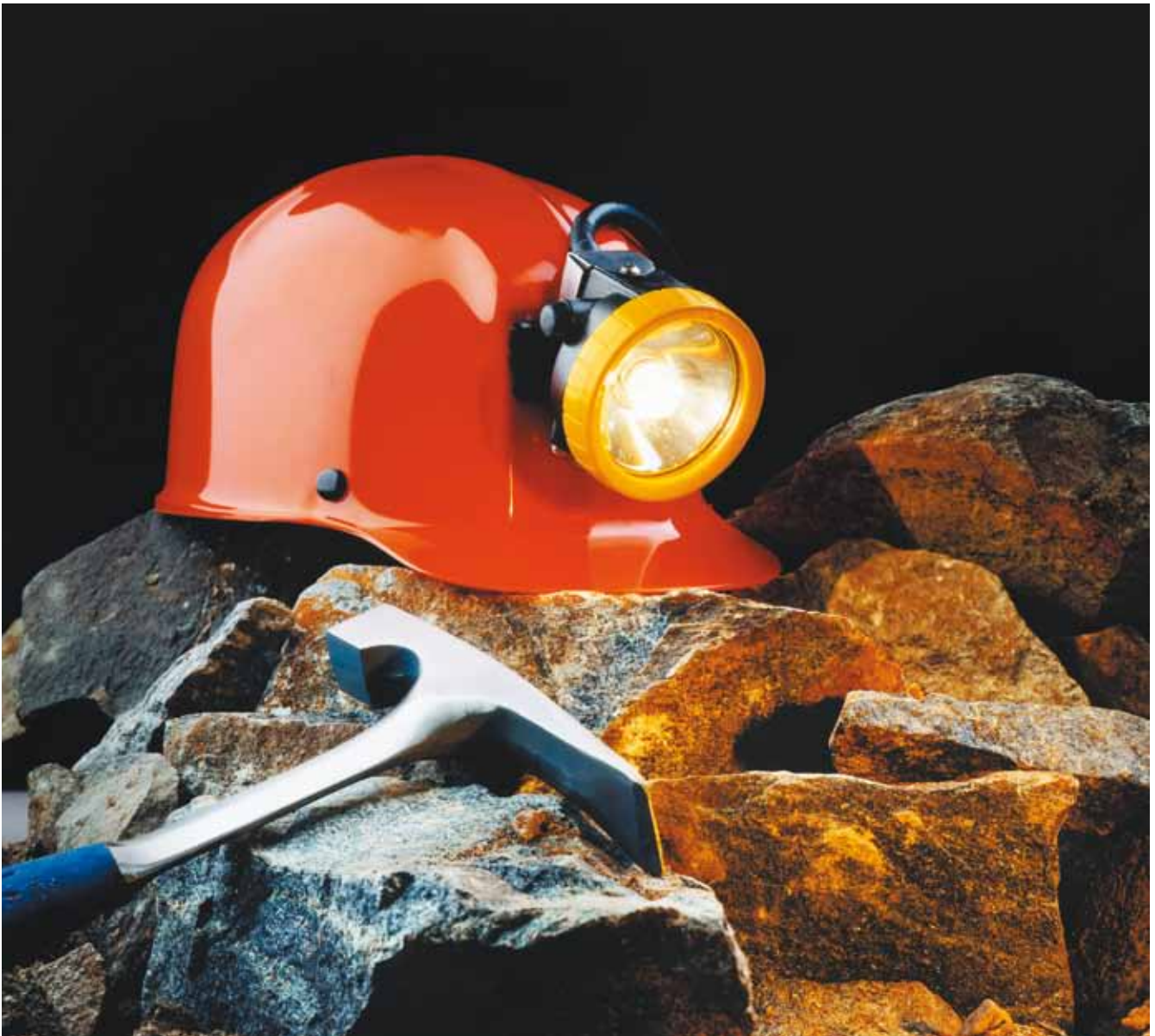
#### Observations

For entities currently applying a successful efforts or an area of interest approach, the proposals represent a significant change because all expenditure would be capitalised, and as a single asset. For entities applying a (modified) full cost approach, in general we would expect only minimal changes in respect of this aspect of the proposals.

We believe that the proposed accounting approach is so different from current practice in respect of other somewhat analogous business activities under IFRSs, such as research and development carried out in the pharmaceutical industry, that the proposals will result in much debate when considered by the IASB given the potentially far-reaching consequences.

In the second half of 2010 the IASB is expected to publish a DP as part of phase B of its joint conceptual framework project with the U.S. Financial Accounting Standards Board; phase B deals with the definitions of elements of the financial statements, including assets, and their recognition and derecognition. Without the exception provided by IFRS 6, at this stage it is unclear to us how the capitalisation of all expenditure, regardless of its result, can meet the criteria required to recognise an asset.

The draft DP appears to start with a larger unit of account than that applied currently, and it is unclear from the proposals the mechanism that would be used for contracting the unit of account as exploration progresses. In our experience, the unit of account applied by most oil and gas entities currently is not as large as proposed in the draft DP, and generally its size does not change significantly as exploration progresses; the approach followed by mining entities typically does result in a contraction of the unit of account over time, based on the identification of an economically recoverable deposit of reserves.



## 4. Measurement

The measurement model applied to assets arising from exploration activities is important because the costs of exploration do not necessarily relate to the overall potential of the site; exploration could result in no future value due to the lack of discovery of commercially viable resources, or in a large value if commercial reserves are found. There has been broad recognition of the shortcomings of the application of the current historical cost accounting model to extractive activities, although a fair value model also has limitations, not least because of the reliability concerns that arise in determining fair value.

### Measurement bases

The draft DP considers three possible measurement bases, and raises significant concerns with each of them:

- Historical cost generally does not represent the potential economic benefits of the underlying reserves and resources; it does not communicate the potential risks of the exploration, or the costs likely to be incurred in extracting the resources.
- A current value, such as fair value, requires significant judgement and, because there are few market-based transactions and assets are far from homogeneous, would need to be based on a large number of assumptions. There is also significant time and cost associated with preparing many value estimates, and the project team is concerned that requiring the use of a current value would not meet the cost-benefit test.
- A mixed historical cost / current value model would allow entities to use historical cost until sufficient information is obtained that would allow a calculation of current value to be performed.

The draft DP proposes the historical cost model, with significant additional disclosure (see 5. *Disclosure*) to allow users to use their own models to calculate the value of an entity's mineral and oil and gas assets.

#### Observations

Notwithstanding the increasing move to fair value that is evident in the work of the IASB, it appears that the level of uncertainty in respect of the eventual outcome of exploration activities is seen as a major obstacle to supporting a fair value model. IASB discussions on this topic indicate that Board members recognise this dilemma, but have requested further research as to whether a measurement based on "fair value" or some other "value" might better represent the value of mineral assets.

### Depreciation

The draft DP does not propose to change existing bases for calculating depreciation, although it highlights some issues relating to the application of the unit-of-production method. One issue is whether the unit-of-production method should be based on revenues or physical units. Another issue is whether the unit-of-production method should be based on proved reserves, proved and probable reserves or another basis that may also include resources. The project team proposes that these issues be addressed in any future standard.

#### Observations

In our experience, typically the unit-of-production method is based on physical units. However, our research has shown diversity in respect of the reserves and resources used in the calculation.<sup>1</sup>

1 *The Application of IFRS: Oil and Gas*, October 2008, page 33; *The Application of IFRS: Mining*, September 2009, page 36.

## Impairment

The draft DP proposes that the requirements of IAS 36 *Impairment of Assets* be applied to assets in the development and production phases.

However, the project team does not agree that IAS 36 can apply to assets in the exploration phase, because generally there is insufficient information available to determine the asset's recoverable amount. As a result, prior to the start of development, the draft DP recommends that assets be tested for impairment only when evidence is available to suggest that the carrying amount of the asset is unlikely to be recovered in full. This means that an asset would not be tested for impairment if there is insufficient or inconclusive evidence regarding its recoverability.

### Observations

Our overall impression of the effects of the proposals is that the statements of financial position of a large number of exploration and production companies, particularly the "juniors," would reflect a high proportion of assets of indeterminable future value prior to production: all expenditure would be capitalised, the unit of account would be very large, and impairment testing prior to development would likely be rare. Combined with the proposed historical cost model, the proposals place a significant burden on the disclosures in the financial statements (see 5. *Disclosure*) and in other investor material to provide users with insight into the quality of the assets recognised in the statement of financial position. That, however, has been the dilemma that the industry has faced over many decades; some assets will be worth less than their historical cost and others very much more than their historical cost.



## 5. Disclosure

Information about an entity’s reserves and resources is critical to users of the financial statements of entities involved in extractive activities. Although requiring disclosure about critical judgements and key sources of estimation uncertainty and “information that is not presented in the financial statements but is relevant to an understanding of any of them”, IFRSs do not address specifically the disclosure of reserves and resources. However, our research has shown that most entities do provide additional disclosures for users, commonly outside of the financial statements<sup>2</sup>; in many cases such disclosures are required by a regulator.

Research carried out by the project team has indicated that users accept that there are inherent limitations in the accounting models proposed (see 4. *Measurement*). However, users, and in particular analysts, rely on additional information provided by the entity that allows them to calculate a “value” for the entity. This value typically will bear little resemblance to the amount of the recognised assets in the financial statements, but rather factors in future exploration potential, risks and cost estimates.

### Disclosure objective

The draft DP recommends disclosures to convey information about:

- the value attributable to an entity’s assets;
- the contribution of these assets to current period performance; and
- the nature and extent of the risks and uncertainties associated with those assets.

The description of “value” in the draft DP refers primarily to the disclosure of physical quantities of reserves. The project team believes that this quantity should reflect the reserves that an entity controls, and should consider the impact of royalty and production-sharing arrangements.

To the extent that an entity has an interest in an area through a joint arrangement, it appears that the reserve quantities would not be included in the disclosure because such arrangements are scoped out of the draft DP. However, the draft DP does discuss interests in an area held through other investments, e.g., an associate; in that case, under the proposals, an entity could present the information if material.

### Disclosures

The draft DP recommends the following disclosures:

Disclosure type	Information to disclose	Level of detail
Reserve quantities	<ul style="list-style-type: none"> <li>• Proved reserves and proved and probable reserves</li> <li>• Estimation method</li> <li>• Main assumptions</li> <li>• Sensitivity analysis to main assumptions</li> <li>• Reconciliation of changes in reserve quantities</li> </ul>	By commodity, and further broken down by country or project (when material)

<sup>2</sup> *The Application of IFRS: Oil and Gas*, October 2008, page 67; *The Application of IFRS: Mining*, September 2009, page 83.

Disclosure type	Information to disclose	Level of detail
Current value measurement (if asset is measured at historical cost)	<ul style="list-style-type: none"> <li>• Option A: Range of fair value estimates</li> <li>• Option B: Standardised measure of proved and probable reserves</li> <li>• Preparation basis</li> <li>• Main assumptions</li> <li>• Reconciliation of changes in current value</li> </ul>	Generally disclosure by major geographical region
Fair value measurement (if asset is measured at fair value)	<ul style="list-style-type: none"> <li>• Fair value estimate</li> <li>• Main assumptions</li> <li>• Sensitivity analysis to main assumptions</li> <li>• Reconciliation of changes in reserve values</li> <li>• Other disclosures similar to exposure draft (ED) <i>Fair Value Measurements</i><sup>3</sup> requirements</li> </ul>	Generally disclosure by major geographical region
Production revenues	<ul style="list-style-type: none"> <li>• Production revenues</li> </ul>	By commodity
Costs	<ul style="list-style-type: none"> <li>• Exploration costs</li> <li>• Development costs</li> <li>• Production costs</li> </ul>	<ul style="list-style-type: none"> <li>• Disaggregated as per reserve quantities</li> <li>• Time series of disclosure over five years</li> </ul>

The project team recommends some disclosures that are not financial in nature, such as reserve volumes. While this information currently is provided outside the financial statements by many entities, reserve volumes are widely used in the financial statements as the basis for depreciation, depletion and amortisation (DD&A) calculations, impairment calculations, and life-of-mine or life-of-field estimates used in decommissioning calculations. In other jurisdictions this information is not required by an accounting standard, but rather by a regulator.

### Observations

One key disclosure that is not mentioned explicitly is information on the expected timing of cash flows, especially near-term cash flows. For many entities projects are operated over a number of years. As a result, the impact of timing is crucial as estimates of the terminal value of the asset and the effect of discounting can alter significantly an estimate of the value of the asset.

The draft DP proposes a single set of disclosure requirements for both the mining and oil and gas industries. In our experience, currently there are significant differences in the disclosures provided between these two industries, particularly relating to the level of detail provided. Mining entities typically present information on a mine-by-mine basis,<sup>4</sup> while oil and gas entities tend to present information on a higher level, such as by geographical region. Entities will need to consider how they would collate the information required for the disclosures and the degree of commercial sensitivity.

3 Published by the IASB in May 2009 with comments to be received by 28 September 2009.

4 *The Application of IFRS: Mining*, September 2009, page 84.

In our experience, joint arrangements and other non-controlled investment vehicles are extremely common in the extractive industries. Accordingly, constituents should consider whether the ability to exclude such reserves information from the financial statement disclosures is appropriate. Another form of owning reserves that are not controlled by an entity is through the acquisition of rights to by-products, e.g., silver produced as part of zinc-mining operations; similar questions arise about the appropriate disclosures in such arrangements.

In our experience, investors assess the progress of exploration and production companies by tracking how particular projects develop over time. This raises the question of whether broader disclosure of different categories of reserves and resources and their development over time would be useful, and if so whether the benefits of such disclosure would outweigh the cost.



## 6. Publish What You Pay proposals

Entities involved in extractive activities operate across a broad range of geographical locations, under a number of differing governmental regimes. Extractive activities may be the primary industry in some of these resource-rich countries and the respective governments generally want to ensure that entities make a significant contribution to the country's development.

One method of achieving this is to implement a fiscal regime that requires a higher contribution from entities conducting these activities. Other methods include requiring the construction or contribution to the cost of building infrastructure, such as ports and roads to and from mine sites, and the provision of social programmes, such as education, housing and medical facilities for mine workers and their families and / or local community.

Publish What You Pay (PWYP) is one organisation that promotes the transparency of payments made to governments in resource-rich countries to assist entities in explaining their contribution to that country.

The draft DP aims to consider a number of different aspects of the accounting for extractive activities and the project team has received input from a number of users and other interest groups. As a result, some specific disclosures have been included in the draft DP based on input from the PWYP organisation, although the draft DP does not include a recommendation as to whether such disclosures should be required in financial statements.

The PWYP organisation recommends the following disclosures, which in our experience some entities already provide, at least in part:

### Benefit streams to government

The significant components of the total benefit streams to government and its agencies should be disclosed on a country-by-country basis. At a minimum, this would include separate disclosure of:

- royalties and taxes paid in cash;
- royalties and taxes paid in kind (measured in cash equivalents);
- dividends;
- bonuses; and
- licence and concession fees.

### Reserves

Reserves volumes and valuation measures, if required by the future IFRS, should be disclosed on a country-by-country basis.

### Production volumes

Production volumes for the current reporting period should be disclosed on a country-by-country basis. Optional disclosure of production volumes by key products and key properties is encouraged.

### Production revenues

Revenues from production should be disclosed on a country-by-country basis, with separate disclosure of production revenue attributable to:

- sales to external customers; and
- transfers to downstream operations.



## Costs

The following costs should be disclosed on a country-by-country basis:

- production costs
- development costs.

## Key subsidiaries and properties

The names and locations of each key subsidiary and property in each country should be disclosed.

### Observations

There are a number of organisations proposing changes to reporting frameworks for corporate social responsibility information. It is not clear to us whether the project team will expand its work to consider this issue more widely.



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