Critical Analysis of BHP’s PPE Disclosures

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Executive Summary

The current report details the findings of the critical review of BHP's PPE disclosures for the period ended June 30, 2020. The alignment of the company's PPE disclosures with the general-purpose financial reporting objective and its satisfaction of the fundamental and enhancing qualities of useful financial information was analysed. The disclosures were shown to be relevant, material, faithfully represented, and well aligned with the objective of providing useful financial information to external users of financial information. There is room for improvement of the understandability of the PPE disclosures and general financial statements.

Introduction

For BHP, the pandemic increased uncertainty that already existed given climate change concerns and anticipated decrease in petroleum demand with respect to our ability to recover the value of mineral rights assets and exploration & evaluation. The board of directors is rightly concerned about the alignment of current PPE disclosures with the financial reporting framework considering the value of these assets: for the period ending June 30, 2020, PPE represented 87% of our total non-current assets and 69% of the total assets. Thus, the misapplication of asset recognition and impairment policies would have a large impact on the faithfulness and reliability of the financial statements to shareholders and other external users.

Critical Analysis of PPE Disclosures

We disclosed our approach to accounting for PPE with respect to recognition and measurement, impairment, and valuation models used in asset impairment in Note 11 to the financial statements, which is presented in the appendix (BHP, 2020). The disclosure is prefaced by a reconciliation of the land & buildings, plant & equipment, assets under construction, exploration & evaluation, and other mineral assets beginning net book values to the end year net book values. In the first sub-note, we summarised the recognition of the five aforementioned asset categories: all PPE assets other than assets under construction, are carried at their original cost less accumulated depreciation and net impairments (BHP, 2020). Assets under construction are a placeholder category that are not depreciated until they are reclassified either as plant & equipment or other mineral assets – which include petroleum rights and mineral interests owned by the company and capitalised product development and overburden removal costs (BHP, 2020). We capitalise the resources expended in the exploration of mineral resources and evaluation of the technical and economic feasibility of extraction under exploration & evaluation and carry the assets at their net book value, which is the cost less accumulated depreciation and transfers (BHP, 2020).

The capitalised amounts are carried forward to the extent that we expect to recover the amount at some point in the future, failing which, the amount is charged to the income statement (BHP, 2020). Capitalised amounts are reclassified as assets under construction once deemed commercially viable, then reclassified as assets on the completion of the construction process (BHP, 2020). Buildings and plant & equipment are depreciated using the straight-line method net of residual value while mineral rights & petroleum interests and capitalised exploration and evaluation expenditures are depreciated using the units of production net of their residual values (BHP, 2020).

The company performs an impairment test on PPE when there is suspicion of impairment and charges an impairment loss to the income statement to reduce the asset’s carrying value to its fair value. In 2020, the impairment loss charged to PPE net of reversals was $494 million, which was considerably higher than the $250 million net impairment loss in 2019 (BHP, 2020). We use the fair value less cost of disposal (FVLCD) and value in use (VIU) valuation methods in the determination of the recoverable amount, against which the asset's carrying value is compared in impairment testing. In an accompanying visual, we summarised management's key judgements in accounting for PPE with respect to climate change, petroleum demand, and COVID-19.

Fundamental and Enhancing Qualitative Characteristics of Useful Financial Information

The fundamental qualitative characteristics of financial information include relevance, materiality, and faithful representation. We provided all the information relevant to external users' decision-making on the provision of resources to BHP, covering all aspects of PPE accounting – initial recognition, subsequent recognition, depreciation, and impairment. While the exposition on recognition of the various PPE asset categories seems lengthy, it is necessary for the understanding of the PPE items specific to the company. Capitalised exploration and evaluation expenditures are for the most part intangible in nature but are reported under PPE as they are to be converted to PPE assets. We also provided information on the estimates and management judgement of events that influenced the presentation of financial statements.

We also satisfied the materiality requirement, by presenting all events – collapsed into seven categories (impact of IFRS16, additions, depreciation, remeasurements of index-linked freight contracts, depreciation, disposal, impairments, and transfers) – that resulted in the changes in the asset net book value over the course of the year. Additions include both purchases and additions from changes in estimates and foreign exchange gains, which were presented in greater detail in Note 14. The financial information is faithfully represented according to the effective accounting policies. We adopted AASB16/IFRS16 on leases in the period ending 30 June 2020, which had the effect of increasing our land & buildings and plant and equipment balances by a combined $2,154 while increasing our lease liabilities balance. The impact of the transition is summarised in the reconciliation and broken down in Note 38 to the financial statements.

The disclosure was for the most extent understandable to a lay person as all mining related jargon are well explained and the language used is simple to understand. The understandability of the information could, however, be improved by summarising all necessary information within the disclosure without requiring the reader to go back and forth between notes as in the case of linked notes such as Note 38 and 14. If this were not possible, the publication should have used active links to accompanying notes facilitate easy movement between notes.

Alignment with General-Purpose Financial Reporting Objective

The objective of general-purpose financial reporting is to provide useful financial information to current and potential investors and other external users of financial information that is relevant to making decisions on whether or not to extend resources to the entity (AASB, 2019). Shareholders and lenders expect that their capital contribution to BHP will be invested in areas that yield returns at least as high as required by the respective owners of capital. The disclosures on PPE are sufficiently aligned with the objectives of general-purpose financial reporting as the company provided sufficient information on the current value of PPE assets and its expectations for the continued revenue generation potential of this assets. The reconciliation of beginning and ending asset values provides sufficient information of the sources of asset growth and causes of decline in the asset balances.

Investment in PPE assets is suggestive of management's expectations for continued growth while minimal impairment losses are indicative of the maintenance of asset value, which also speaks to business continuity. Investors can, for instance, compare the company's disclosure of asset impairments in the current period to the previous period to determine the extent to which management is confident of the continued usefulness of its assets. In our case, the 2020 impairment loss was almost twice the 2019 loss but still fairly low, at 0.68% of the ending net book value.

Recommendations

In the upcoming period, management should enhance the understandability of the financial information by providing active links to different sections of the financial statement in the table of contents and an active link back to the table of contents from each page of the report. We could also present a more comprehensive disclosure of the asset impairment process and indicate the effect of impairment on the subsequent recognition of assets. Even though the summary of the impairment process is sufficient, we failed to incorporate the impairment charge in the recognition sub-note, which might be lost to users with no accounting background. In the recognition sub-note, we indicated that capitalised evaluation and exploration costs that are deemed irrecoverable are charged to the income statement without indicating that the charge relates to asset impairment. Combining these two elements will improve the understandability of the income statement.

Conclusion

The disclosures satisfied the objective of general-purpose financial reporting and met the fundamental qualitative characteristics of useful financial information. There is, however, room for improvement with respect to the understandability of financial information.

References

AASB (2019). Conceptual Framework for Financial Reporting. Retrieved from: https://www.aasb.gov.au/admin/file/content105/c9/Conceptual_Framework_05-19.pdf

BHP (2020). Annual report. Retrieved from: https://www.bhp.com/investors/annual-reporting

Appendix

Resource assets

11 Property, plant and equipment

	Land and buildings US$M	Plant and equipment US$M	Other mineral assets US$M	Assets under construction US$M	Exploration and evaluation US$M	Total US$M
Net book value – 30 June 2020						
At the beginning of the financial year	**7,885**	**38,174**	**9,211**	**11,149**	**1,622**	**68,041**
Impact of adopting IFRS 16 [1]	**754**	**1,400**	**–**	**–**	**–**	**2,154**
Additions [2]	**115**	**1,719**	**684**	**6,100**	**218**	**8,836**
Remeasurements of index-linked freight contracts [3]	**–**	**733**	**–**	**–**	**–**	**733**
Depreciation for the year	**(630)**	**(5,104)**	**(294)**	**–**	**–**	**(6,028)**
Impairments, net of reversals	**(17)**	**(189)**	**(288)**	**–**	**–**	**(494)**
Disposals	**(12)**	**(22)**	**–**	**–**	**(65)**	**(99)**
Transfers and other movements	**292**	**2,718**	**(661)**	**(3,475)**	**345**	**(781)**
At the end of the financial year [4]	**8,387**	**39,429**	**8,652**	**13,774**	**2,120**	**72,362**
– Cost	**13,932**	**97,230**	**13,736**	**13,774**	**2,899**	**141,571**
– Accumulated depreciation and impairments	**(5,545)**	**(57,801)**	**(5,084)**	**–**	**(779)**	**(69,209)**
Net book value – 30 June 2019						
At the beginning of the financial year	8,152	40,885	8,974	7,554	1,617	67,182
Additions [2]	5	515	1,023	5,799	418	7,760
Depreciation for the year	(585)	(4,885)	(277)	–	–	(5,747)
Impairments, net of reversals	(9)	(234)	–	–	(7)	(250)
Disposals	(2)	(40)	(5)	–	–	(47)
Transferred to assets held for sale	–	–	–	(331)	–	(331)
Exchange variations taken to reserve	–	(1)	–	–	–	(1)
Transfers and other movements	324	1,934	(504)	(1,873)	(406)	(525)
At the end of the financial year [4]	7,885	38,174	9,211	11,149	1,622	68,041
– Cost	12,825	92,090	13,681	11,149	2,404	132,149
– Accumulated depreciation and impairments	(4,940)	(53,916)	(4,470)	–	(782)	(64,108)

(1) Refer to note 38 ‘New and amended accounting standards and interpretations’.
(2) Includes change in estimates and net foreign exchange gains/(losses) related to the closure and rehabilitation provisions for operating sites. Refer to note 14 ‘Closure and rehabilitation provisions’.
(3) Relates to remeasurements of index-linked freight contracts including continuous voyage charters (CVCs). Refer to note 20 ‘Leases’.
(4) Includes the carrying value of the Group’s right-of-use assets relating to land and buildings and plant and equipment of US$3,047 million (2019: US$492 million relating to finance leases). Refer to note 20 ‘Leases’ for the movement of the right-of-use assets during FY2020.

Recognition and measurement

Property, plant and equipment

Property, plant and equipment is recorded at cost less accumulated depreciation and impairment charges. Cost is the fair value of consideration given to acquire the asset at the time of its acquisition or construction and includes the direct costs of bringing the asset to the location and the condition necessary for operation and the estimated future costs of closure and rehabilitation of the facility.

Exploration and evaluation

Exploration costs are incurred to discover mineral and petroleum resources. Evaluation costs are incurred to assess the technical feasibility and commercial viability of resources found.

Exploration and evaluation expenditure is charged to the income statement as incurred, except in the following circumstances in which case the expenditure may be capitalised:

In respect of minerals activities:

- the exploration and evaluation activity is within an area of interest that was previously acquired as an asset acquisition or in a business combination and measured at fair value on acquisition; or
- the existence of a commercially viable mineral deposit has been established.

In respect of petroleum activities:

- the exploration and evaluation activity is within an area of interest for which it is expected that the expenditure will be recouped by future exploitation or sale; or
- exploration and evaluation activity has not reached a stage that permits a reasonable assessment of the existence of commercially recoverable reserves.

A regular review of each area of interest is undertaken to determine the appropriateness of continuing to carry forward costs in relation to that area. Capitalised costs are only carried forward to the extent that they are expected to be recovered through the successful exploitation of the area of interest or alternatively by its sale.
To the extent that capitalised expenditure is no longer expected to be recovered, it is charged to the income statement.

Key judgements and estimates

Judgements: Exploration and evaluation expenditure results in certain items of expenditure being capitalised for an area of interest where a judgement is made that it is likely to be recoverable by future exploitation or sale, or where the activities are judged not to have reached a stage that permits a reasonable assessment of the existence of reserves.

Estimates: Management makes certain estimates and assumptions as to future events and circumstances, in particular when making quantitative assessment of whether an economically viable extraction operation can be established. These estimates and assumptions may change as new information becomes available. If, after having capitalised the expenditure under the policy, new information suggests that recovery of the expenditure is unlikely, the relevant capitalised amount is charged to the income statement.

11 Property, plant and equipment continued

Depreciation

Depreciation of assets, other than land, assets under construction and capitalised exploration and evaluation that are not depreciated, is calculated using either the straight-line (SL) method or units of production (UoP) method, net of residual values, over the estimated useful lives of specific assets. The depreciation method and rates applied to specific assets reflect the pattern in which the asset's benefits are expected to be used by the Group. The Group's reported reserves are used to determine UoP depreciation unless doing so results in depreciation charges that do not reflect the asset's useful life. Where this occurs, alternative approaches to determining reserves are applied, such as using management's expectations of future oil and gas prices rather than yearly average prices, to provide a phasing of periodic depreciation charges that better reflects the asset's expected useful life.

Where assets are dedicated to a mine or petroleum lease, the below useful lives are subject to the lesser of the asset category's useful life and the life of the mine or petroleum lease, unless those assets are readily transferable to another productive mine or lease.

Key estimates

The determination of useful lives, residual values and depreciation methods involves estimates and assumptions and is reviewed annually. Any changes to useful lives or any other estimates or assumptions may affect prospective depreciation rates and asset carrying values. The table below summarises the principal depreciation methods and rates applied to major asset categories by the Group.

Category	Buildings	Plant and equipment	Mineral rights and petroleum interests	Capitalised exploration, evaluation and development expenditure
Typical depreciation methodology	SL	SL	UoP	UoP
Depreciation rate	25–50 years	3–30 years	Based on the rate of depletion of reserves	Based on the rate of depletion of reserves

Commitments

The Group's commitments for capital expenditure were US$2,585 million as at 30 June 2020 (2019: US$3,308 million). The Group's commitments related to leases are included in note 20 'Leases'.

Impairment of non-current assets

Recognition and measurement

Impairment tests for all assets are performed when there is an indication of impairment, although goodwill is tested at least annually. If the carrying amount of the asset exceeds its recoverable amount, the asset is impaired and an impairment loss is charged to the income statement so as to reduce the carrying amount in the balance sheet to its recoverable amount.

Previously impaired assets (excluding goodwill) are reviewed for possible reversal of previous impairment at each reporting date. Impairment reversal cannot exceed the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognised for the asset or cash generating units (CGUs). There were no reversals of impairment in the current or prior year.

How recoverable amount is calculated

The recoverable amount is the higher of an asset's fair value less cost of disposal (FVLCD) and its value in use (VIU). For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows.

Valuation methods

Fair value less cost of disposal

FVLCD is an estimate of the amount that a market participant would pay for an asset or CGU, less the cost of disposal. FVLCD for mineral and petroleum assets is generally determined using independent market assumptions to calculate the present value of the estimated future post-tax cash flows expected to arise from the continued use of the asset, including the anticipated cash flow effects of any capital expenditure to enhance production or reduce cost, and its eventual disposal where a market participant may take a consistent view. Cash flows are discounted using an appropriate post-tax market discount rate to arrive at a net present value of the asset, which is compared against the asset's carrying value. FVLCD may also take into consideration other market-based indicators of fair value.

Value in use

VIU is determined as the present value of the estimated future cash flows expected to arise from the continued use of the asset in its present form and its eventual disposal. VIU is determined by applying assumptions specific to the Group's continued use and cannot take into account future development. These assumptions are different to those used in calculating FVLCD and consequently the VIU calculation is likely to give a different result (usually lower) to a FVLCD calculation.