

Oil Industry Accounting Committee

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CL 67

1 September 2004

Dear Mr Fleming

ED6 – Exploration for and Evaluation of Mineral Resources

The Oil Industry Accounting Committee (“OIAC”) is pleased to submit its further comments on the IASB’s exposure draft “ED6 – Exploration for and Evaluation of Mineral Resources” following the IASB’s redeliberations in July 2004, and in response to the IASB’s invitation to comment dated 3 August.

OIAC is recognised by the UK Accounting Standards Board (“ASB”) for the purposes of issuing Statements of Recommended Practice (“SORPs”) for the upstream oil and gas sector. Under UK accounting standards, entities with activities in the upstream oil and gas sector are required to refer specifically to OIAC’s SORP, state whether their financial statements comply with it, and justify any departures from it.

OIAC continues to support the objective identified in paragraph 1(a) of ED6, which is to make limited improvements to accounting practices, without requiring major changes that may be reversed when the Board undertakes a comprehensive review. In the absence of a standard based on ED6, oil and gas exploration and production (“E&P”) entities would be able to refer only to generally applicable guidance in IFRS and the IFRS framework, and OIAC believes that a spectrum of differing accounting practices, based on a range of differing interpretations of IFRS requirements, would result. At present, whilst there are admittedly two distinct prevalent methods of accounting in the E&P sector – the “full cost” and “successful efforts” methods – both are well established in the UK and internationally, consistently applied and well understood by users of financial statements. OIAC believes that existing consensus around these two methods should be preserved, at least until such time as the IASB undertakes its comprehensive review.

OIAC agrees that an entity should assess whether there is any indication that an exploration and evaluation asset may be impaired, and welcomes the clarification now proposed by the Board, that impairment should be subject to a full IAS 36 impairment test only when specific facts and circumstances indicate, using the criteria set out in paragraph 13, rather than annually. However, OIAC notes that paragraph 10 of IAS 36 states that

“an intangible asset not yet available for use [is tested] for impairment annually by comparing its carrying amount with its recoverable amount”

OIAC recommends that the IASB addresses this apparent inconsistency by stating explicitly in ED6 that an annual test is not required for E&E assets, even if classified as intangibles.

OIAC also had reservations about the originally proposed definition of a cash generating unit (“CGU”) for exploration and evaluation (“E&E”) assets. In the paragraphs which follow, OIAC has set out its assessment of whether the IASB’s revised proposal, of deleting the definition and related parts of ED6, is appropriate.

In summary, under the UK SORP, E&P companies will often initially recognise E&E expenditures as stand-alone assets at the licence or well level if no commercial reserves have yet been established in the field or region, or otherwise, as an addition to the total E&E costs of the field (successful efforts accounting) or cost pool (full cost accounting) if commercial reserves already exist. In the case of a standalone E&E asset, once the outcome of E&E is known it is either impaired, or, subsumed together with the development and other costs within a new field cost centre or cost pool, as appropriate.

OIAC has considered the effect of the IASB’s current proposals in each of the following situations where it has been assumed that facts and circumstances (with reference to paragraph 13 of ED6) would require an IAS 36 impairment test to be performed:

- Where E&E expenditures have initially been recognised as a stand-alone asset, an IAS 36 impairment test would result in the E&E asset being written off, broadly in line with current practice for successful efforts companies.
- For full cost companies, E&E expenditures under the SORP are permitted to be initially recognised as additions to the E&E cost of an existing pool, or alternatively to be recognised as stand-alone E&E assets separate from any pool, (even where a pool already exists). Under the latter option, E&E costs are later transferred to the the cost pool on completion of E&E, whether or not E&E is successful, whereas under the IASB’s proposals, impaired E&E assets would instead be charged to the profit and loss account. This represents a departure from existing practice under the SORP. However, OIAC’s understanding is that the former option for full cost accounting under the SORP, whereby E&E expenditures are not held outside of an existing pool, should continue to be available under the IASB’s proposals.
- Where E&E expenditures are recognised as an addition to the E&E asset of an existing field or cost pool, an impairment test of the E&E asset under IAS 36 should result in test at the field or cost pool level, since this is the level at which E&E expenditures (and other development costs) are recognised as “individual assets” for the purposes of IAS 36 paragraph 66. Generally, further aggregation above the field or cost pool level will not be necessary as cash flows at the field or cost pool level will be largely independent of other field or cost pools. Consequently, the IASB’s proposals appear to result in impairment testing at a level which is generally in line with current practice.

OIAC has also considered the comment included in the Endnote to the paper summarising the effect of the IASB’s re-deliberations, which suggests that an individual producing well would represent a CGU. OIAC does not believe that this accurately reflects the operational reality of the industry, nor existing accounting practice under the SORP, for the following reasons:

- Following a commercial discovery, the “individual asset” for accounting purposes is not any particular well, but rather the body of oil or gas it has discovered. Indeed, it may only be subsequent development wells that are used to produce the oil or gas, and the exploration well itself may not in fact be used to produce (or be capable of producing) the reserves. Any impairment test of the discovery under IAS 36 would be applied at least at the level of the “individual asset”, being the body of reserves as a whole, rather than to any individual component of the asset, such as a particular well.

- Unless a single well is capable of producing economic quantities of oil or gas of itself, the existence of any “future cash inflows that are ... capable of reliable measurement” remains dependent upon the existence of further wells in order to achieve a level of production which is commercially viable. Furthermore, where a single field is produced through a number of wells, the performance of each well is likely to depend upon the others, and the cash inflows associated with each well are unlikely to be independent. Consequently, even if the view was taken each well, rather than the body of reserves associated with the field, represented the “individual asset”, a CGU would rarely exist at a lower level than a field.

Provided that the final drafting of ED6, and in particular the proposed redrafting of paragraph 4, continues to permit E&P companies to recognise E&E expenditures as individual assets at the field or cost pool level, in line with both existing accounting practice under the SORP and the operational realities of the industry, then a specific definition of a GCU for E&E assets to allow impairment to be tested at this same level should be redundant. However, since the wording of paragraph 4 may be crucial, OIAC recommends that the IASB exposes the proposed wording of the revised paragraph 4 for comment before the IFRS is finalised.

As stated in our previous response, OIAC continues to believe that once impaired E&E assets should not be reinstated as recognition of such a reversal is inappropriate for properties in the E&E stage. Accordingly, OIAC recommends an exception from recognising any impairment reversal, similar to that in existence on IAS 36 for goodwill, should be included in ED6.

If you have any questions concerning our comments, please do not hesitate to contact me at the telephone number or email address shown above.

Yours sincerely

Alan Thomas

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