ERNST & YOUNG

Ernst & Young Global Limited
Becket House
1 Lambeth Palace Road
London SE1 7EU

Phone: [44] 20 7980 2000
Fax: [44] 20 7980 0275

Web site: http://www.ey.com

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Mr C Fleming
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Sir/Madam

ED 6 *Exploration for and Evaluation of Mineral Resources* – level at which impairment is assessed

We are pleased to have the opportunity to comment on the above issue.

The Board's overall objective in issuing ED 6 was, in its own words, 'to propose an interim solution to enable entities reporting exploration and evaluation assets to comply with IFRSs while avoiding wholesale change to their accounting policies', acknowledging that 'accounting practices for such activities are diverse'. The Board sought to do this principally by allowing entities reporting exploration and evaluation assets to continue to account for such assets using their existing accounting policies and to assess the assets concerned for impairment annually at the level of 'a cash-generating unit (CGU) for exploration and evaluation assets'.

In its redeliberation of ED 6, the Board is proposing to eliminate the special CGU for exploration and evaluation assets. The Board is also proposing to eliminate the requirement to test capitalised exploration and evaluation expenditure for impairment annually and instead to require an impairment of an exploration and evaluation asset to be recognised 'when specific facts and circumstances indicate that the carrying amount of such an ass et exceeds its recoverable amount'.

These changes to ED 6 are fundamental in nature. However, the Board's commentary on the implications of the changes is extremely brief. Rearranging its statements into a logical sequence produces the following result:

1. the result of eliminating the special CGU for exploration and evaluation assets 'is that all entities recognising exploration and evaluation assets would be required to test those assets for impairment using CGUs defined by IAS 36';
2. IAS 36 requires impairment to be assessed at the individual asset level 'unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets';
3. 'in some cases in which exploration and evaluation assets are recognised, eg in the petroleum sector, each well is capable of producing future cash flows that are observable and capable of reliable measurement because there is an active market for crude oil';
4. therefore, 'requiring entities to use IAS 36 CGUs would force entities recognising exploration assets to test for impairment at a very low level'.

The Board's conclusion is reflected in its proposal to eliminate from ED 6 the requirement for entities to disclose the level at which they assess exploration and evaluation assets for impairment.

In our view, the Board's analysis is simplistic. The Board's analysis seems to imply that exploration and evaluation assets themselves generate cash flows, which is not the case, and it asserts that such cash flows must be attributed to 'a low level' of exploration and evaluation assets based on production wells in the petroleum sector, without explaining how this relates to exploration and evaluation assets. Given the diversity of current accounting practices for exploration and evaluation expenditures and the significance of the changes it is proposing to make to ED 6, it would have been reasonable to expect the Board to explain more fully the implications of its proposed changes to ED 6, with specific examples of how the level at which exploration and evaluation assets would be tested for impairment would be determined under the revised draft of ED 6.

Having eliminated the special CGU for exploration and evaluation assets, a key question that the Board must address directly, but which is not addressed in the revised draft, is what constitutes an (individual) exploration and evaluation CGU - the ED as revised merely describes the types of expenditure that are included in the measurement of exploration and evaluation assets as a whole. ED 6 enabled exploration and evaluation assets to be allocated to the (development and production) asset groups to which impairment tests were applied under a company's pre-IFRS accounting policies (although it did not include any further guidance about what the connection or relationship should be between the 'group of assets' and the exploration and evaluation assets in order for the exploration and evaluation assets to be aggregated with the 'group of assets' - a shortcoming we pointed out in our comment letter on ED 6 - and said merely that a CGU for exploration and evaluation assets could be no larger than a segment).

However, as a result of the changes to ED 6 proposed by the IASB, exploration and evaluation assets would stand on their own for the purpose of impairment tests. Since exploration and evaluation assets (1) do not by definition of themselves generate cash flows; (2) consist of many types of cost that do not relate directly to individual wells or other similar exploratory drilling activities; and (3) are currently aggregated in substantially different ways by entities engaged in exploration and evaluation activities, it is not sufficient for the Board merely to assert that 'requiring entities to use IAS 36 CGUs would force entities recognising exploration assets to test for impairment at a very low level'. Indeed, we would question whether it is appropriate to conclude based on the analogy of crude oil *production* assets that impairment of *exploration* assets must be carried out at 'a very low level'.

As we have already noted, a key question that would need to be addressed in the revised ED 6 (if it were to become an IFRS) is what constitutes an individual exploration and evaluation asset? Is it an individual exploratory well, a license area, or will it be acceptable, as companies using the full cost method of accounting currently do, to aggregate license areas, or to regard a whole country or even a region as a single exploration and evaluation asset?

Even in the case of the successful efforts method of accounting, much exploration and evaluation expenditure relates to the license area or geological structure as a whole rather than to individual wells or similar exploratory drilling activities. In any event, exploratory wells that discover oil are often not used to produce crude oil, and before crude oil can be produced commercially appraisal and development wells must be drilled, some of which may be dry but may be capitalised. Entities that apply the full cost method of accounting regard their exploration and evaluation costs as relating to 'cost pools' that might span an area of interest, a geological basin, a country or a region, and would argue that regarding each exploratory well as a separate CGU does not reflect the economic reality of their activities. Accordingly, on completion of an exploration and evaluation programme, the expenditures concerned are transferred to the relevant cost pool, whether or not the particular programme is successful.

In order, therefore, to enable the implications of the changes to ED 6 that the Board is proposing and its conclusion that the changes ‘would force entities recognising exploration assets to test for impairment at a very low level’ to be understood, the Board would have to address these issues in a revised ‘Basis for Conclusions’ and possibly also in implementation guidance.

If there is a valid rationale for the Board’s conclusion that impairment testing of exploration assets would have to be carried out at a very low level, this would impose a fundamental change of accounting on many entities engaged in exploration for and evaluation of mineral resources. In our view such a change should not be imposed without a full re-exposure of ED 6. Indeed, as the accounting for E&E costs is probably the most difficult extractive industries accounting issue of all, we believe it would not be appropriate to introduce such a fundamental change in accounting before the comprehensive review of extractive industries accounting has been completed. The IASB has already decided to postpone until 1 January 2006 the effective date of the standard based on ED 6 (although this is a cosmetic change to the extent that companies adopting IFRS from 2005 will have to early adopt the standard). In our view the IASB should either issue a standard based on the special CGU for exploration and evaluation assets as defined in ED 6 or it should scrap ED 6 completely and speed up the comprehensive review with a view to introducing a comprehensive industry standard from 1 January 2007.

Should you wish to discuss this letter with us, please contact David Lindsell on 020 7980 0106.

Yours faithfully

Ernst & Young