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Mr Colin Fleming
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30 Cannon Street
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Dear Mr Fleming

ED 6: Exploration for and Evaluation of Mineral Resources

The global organisation of Ernst & Young is pleased to submit its comments on ED 6 *Exploration for and Evaluation of Mineral Resources*.

Ernst & Young supports the stated objectives of ED 6. However, as acknowledged in paragraph BC3(c), accounting practices for exploration and evaluation expenditures are diverse. It is, therefore, inevitable that a proposed IFRS which sets out requirements only for measurement and impairment of exploration and evaluation expenditures while at the same time allowing an entity to continue to recognise and measure exploration and evaluation assets in accordance with its previous accounting policies will raise a great many questions relating to the practical application of the requirements and the extent to which previous accounting practices must be changed in order to meet them. Indeed, in our view the proposed IFRS is open to such a variety of interpretation that it will do little to improve the comparability of financial statements of entities engaged in exploration and evaluation of mineral resources and could, in countries in which detailed guidance on measurement and impairment has hitherto been applied by entities engaged in mineral resources exploration and evaluation, result in greater diversity in accounting practices. We believe that if this is to be avoided, the IASB must explain the requirements of the proposed IFRS in greater detail and by reference to practical examples in its Basis for Conclusions or accompanying application guidance.

In any event, however, the proposed IFRS represents a pragmatic, temporary solution and we strongly encourage the IASB to commit itself to complete its comprehensive project on accounting and financial reporting by entities engaged in extractive activities by 2007 at the latest.

We set out below our response to each of the questions asked in the exposure draft.

Question 1 - Definition and additional guidance

The proposed IFRS includes definitions of exploration for and evaluation of mineral resources, exploration and evaluation expenditures, exploration and evaluation assets and a cash generating unit for exploration and evaluation assets. The draft IFRS identifies expenditures

that are excluded from the proposed definition of exploration and evaluation assets. Additional guidance is proposed in paragraph 7 to assist in identifying exploration and evaluation expenditures that are included in the definition of an exploration and evaluation asset (proposed paragraphs 7 and 8, Appendix A and paragraphs BC12-BC14 of the Basis for Conclusions).
Consistent with our comments above on the need for detailed explanations of the requirements of the proposed IFRS, we support the approach of listing in paragraph 7 the categories of directly attributable expenditure that may be included in the initial measurement of exploration and evaluation assets, as opposed to the approach of giving only examples of such expenditure (as is done, for example, in paragraph 17 of IAS 16). We are not aware of any other categories of expenditure that might be considered to be suitable for inclusion but should there be any other such categories they should be added to the list in paragraph 7.

We agree that, as stated in paragraph 8(b), administration and other general overhead costs should not be included in the initial measurement of exploration and evaluation assets. However, the question of what constitutes 'administration and other general overhead costs' is frequently of particular significance for entities engaged in mineral resources exploration and evaluation activities, especially where the entity's activities are focused on a small number of (possibly remote) locations. In such cases, some entities regard virtually all their expenditures as directly attributable to the exploration for and evaluation of mineral resources. In this regard, we note that by contrast with paragraph 19(c) of IAS 16 and paragraph 29 of IAS3 8 (which, like paragraph 8 of ED 6 refer to administration and other general overhead costs), paragraph 8 of ED 6 does not require costs of conducting business in a new location to be excluded in measuring the cost of the asset.

Paragraph 4 of the proposed IFRS permits an entity to continue to apply its previous accounting policies 'except as provided in paragraph 8' and paragraph BC13 states that the Board "is unwilling to base the definition [of exploration and evaluation assets] used for accounting purposes on local definitions that may vary from country to country". However, this exception is not discussed further in the Basis for Conclusions. In our view the IASB should make clear (in the Basis for Conclusions or accompanying application guidance) how it wishes paragraph 8(b) to be interpreted and applied by entities engaged in exploration for and evaluation of mineral resources. In this regard, it might be appropriate to apply a similar approach to that set out in paragraph 15 etc of IAS 2 in relation to the inclusion in or exclusion from inventories of "other costs".

Question 2 - Method of accounting for exploration for and evaluation of mineral resources

(a) Paragraphs 10-12 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors specify sources of authoritative requirements and guidance an entity should consider in developing an accounting policy for an item if no IFRS applies specifically to that item. The proposals in the draft IFRS would exempt an entity from considering the sources in paragraphs 11 and 12 when assessing its existing accounting policies for exploration and evaluation expenditures by permitting an alternative treatment for the recognition and measurement of exploration and evaluation assets. In particular, the draft IFRS would permit an entity to continue to account for exploration and evaluation assets in accordance with the accounting policies applied in its most recent annual financial statements.

(b) The Exposure Draft proposes that an entity would continue to use its existing accounting policies in subsequent periods unless and until the entity changes its accounting policies in accordance with IAS 8 or the IASB issues new or revised Standards that encompass such activities (proposed paragraph 4 and paragraphs BC8-BC11 of the Basis for Conclusions).

Are these proposals appropriate? If not, why not?

In our view the proposals are generally appropriate. However, entities that commence exploration and evaluation activities would have no existing accounting practices in relation to exploration for and evaluation of mineral resources that they continue to apply. In our view, the only appropriate and practicable approach would be to permit such entities to adopt accounting policies which represent generally accepted practice for such activities in their country. Also, an entity engaged in exploration for and evaluation of mineral resources that is acquired should be permitted to bring its accounting policies for the recognition and measurement of exploration and evaluation assets into line with those of its parent company provided that the parent company is in compliance with the proposed IFRS.

Question 3— Cash-generating units for exploration and evaluation assets

[Draft] IAS 36 requires entities to test non-current assets for impairment. The draft IFRS would permit an entity that has recognised exploration and evaluation assets to test them for impairment on the basis of a 'cash-generating unit for exploration and evaluation assets' rather than the cash-generating unit that might otherwise be required by [draft] IAS 36. This cash-generating unit for exploration and evaluation assets is used only to test for impairment of exploration and evaluation assets recognised under proposed paragraph 4 (see proposed paragraphs 12 and 14 and paragraphs BC15-BC23 of the Basis for Conclusions).
Are the proposals appropriate? If not, why not? If you disagree with the proposal that exploration and evaluation assets should be subject to an impairment test under [draft] IAS 36, what criteria should be used to assess the recoverability of the carrying amount of exploration and evaluation assets?

Requirements to carry out impairment tests

From discussions with our clients and among members of our organisation, it is apparent that the wording of paragraphs 12 and 14 is open to significantly different interpretations. Some read the need to "assess" exploration and evaluation assets "for impairment annually" in paragraph 12 and the statement in paragraph 14 "when an entity first applies this [draft] IFRS, it shall elect to test exploration and evaluation assets for impairment..." as requiring an impairment test to be performed on initial application of the IFRS *regardless of whether any indication of impairment loss, as specified in paragraph 9 of IAS 36 and paragraph 13 of the proposed IFRS is present,* and possibly also as requiring an impairment test to be performed annually. The difficulty of interpretation is compounded by the phrase "except as provided in paragraph 14" in paragraph 12, as paragraph 14 suggests that exploration and evaluation assets are subject to assessment for impairment annually whether this is done on the basis of a 'cash-generating unit' or a 'cash-generating unit for exploration and evaluation assets'.

Such an approach would be inconsistent with IAS 36 and would be at odds with the rationale for offering an alternative form of cash-generating unit as set out in paragraphs BC 17 and BC 19. However, in view of the different interpretations of the meaning of paragraph 12 and paragraph

14 that are possible, we suggest that the phrasing of paragraph 12 should be consistent with paragraph 9 of IAS 36. Specifically, paragraph 12 should say "shall assess annually whether there is any indication that those assets may be impaired" rather than "shall assess those assets for impairment annually", and paragraph 14 should say "it shall elect to assess whether there is any indication that exploration and evaluation assets may be impaired" rather than "it shall elect to test exploration and evaluation assets for impairment".

Definition of 'cash-generating unit for exploration and evaluation assets'

From discussions with our clients and among members of our organisation, the definition of 'cash-generating unit for exploration and evaluation assets' is also causing confusion. This in part arises because the rationale for introducing the alternative definition of a 'cash-generating unit for exploration and evaluation assets' is somewhat circular in that, according to paragraph BC 17, the IAS 36 definition of a 'cash-generating unit' would 'negate the effects of the other proposals in this draft IFRS'.

A 'cash-generating unit for exploration and evaluation assets' is defined as "the smallest identifiable group of assets that, together with exploration and evaluation assets, generates cash inflows from continuing use on which impairment tests were performed by an entity under the accounting policies applied in its most recent financial statements". We recognise the difficulty of arriving at a rational definition that will avoid triggering the recognition of substantial impairment losses. However, this definition is problematic in that entities engaged in exploration and evaluation activities have generally not in practice combined their exploration and evaluation assets with their 'cash-generating units' for the purpose of impairment testing and by allowing an entity to elect to apply this definition, the proposed IFRS gives them the opportunity to change their approach.

In many cases, for example oil companies that apply the 'successful efforts' method of accounting and mining companies that apply a similar approach, the definition cannot be reconciled with their existing accounting practices, under which an individual well or prospect is written off, unless the results indicate that hydrocarbon or mineral reserves exist and there is a reasonable prospect that these reserves are capable of being produced commercially. We would not support a change whereby, on applying the proposed IFRS, entities were able to avoid an impairment charge by aggregating unsuccessful exploration and evaluation expenditure with a 'cash-generating unit' and the IFRS should make it clear that such a change in approach is not permissible.

Where an entity elects to apply the 'cash-generating unit for exploration and evaluation assets' approach, it will need to allocate its exploration and evaluation assets to the groups of assets it has previously identified for the purpose of assessing impairment. As the definition of a 'cash-generating unit for exploration and evaluation assets' in the proposed IFRS does not require these asset groups to meet the criterion of generating cash inflows that are largely independent of each other, it will enable far larger asset groups to be used for the purpose of assessing impairment of exploration and evaluation assets and will reduce the likelihood of having to recognise impairment losses. However, it is not clear from the definition what the connection or relationship should be between the "group of assets" and the "exploration and evaluation assets" in order for the latter to be aggregated with the former for the purpose of impairment tests. We understand the difficulty of introducing a new definition of the boundaries of a 'cash-generating unit for exploration and evaluation assets' but in our view the IFRS should make it clear that the exploration and evaluation assets must be aggregated with the asset groups in a rational and consistent manner.

After setting out the option of applying the 'cash-generating unit for exploration and evaluation assets', paragraph 14 of the proposed IFRS goes on to say that any assets other than exploration and evaluation assets included within the cash-generating unit for exploration and evaluation assets must continue to be subject to impairment testing in accordance with draft IAS 36. We assume that for this purpose the IASB intends to allow entities to continue to use their existing asset groups even though, in the case of entities that apply a form of the full cost method, such asset groups may not meet the definition of a cash-generating unit. Although this issue relates to assets other than exploration and evaluation assets, in view of the reference to impairment testing of such assets in paragraph 14 it needs to be clarified in this IFRS or the Basis for Conclusions.

Question 4— Identifying exploration and evaluation assets that may be impaired

The draft IFRS identifies indicators of impairment for exploration and evaluation assets. These indicators would be among the external and internal sources of information in paragraphs 9-13 of [draft] IAS 36 that an entity would consider when identifying whether such assets might be impaired (paragraph 13 and paragraphs BC24-BC26 of the Basis for Conclusions).

Are these indicators of impairment for exploration and evaluation assets appropriate? If not, why not? If you are of the view that additional or different indicators should be used in assessing whether such assets might be impaired, what indicators should be used and why?

In discussions with our clients and with members of our own organisation about the indicators of impairment listed in paragraph 13, differences of interpretation have arisen in relation to the meaning of indicator (f) ie "the entity does not expect the recognised exploration and evaluation assets to be reasonably capable of being recoverable from a successful development of the specific area, or by its sale". In our view, the phrase "the entity does not expect" requires an entity to have concluded that there is no reasonable expectation that further exploration and evaluation of the area concerned will identify commercial reserves. However, some have read the words in (f) as requiring an entity to have positive evidence that the assets *will* be reasonably capable of being recoverable. To avoid differences of interpretation we suggest that a fuller explanation is provided in the Basis for Conclusions.

Paragraph 13 states that IAS 36 requires an entity to "consider specified external sources of information" whereas in fact it requires both external and internal factors to be considered. Moreover, the indicators listed in paragraph 13 include both external and internal information.

Question 5 — Disclosure

To enhance comparability, the draft IFRS proposes to require entities to disclose information that identifies and explains the amounts in its financial statements that arise from the exploration for and evaluation of mineral resources (proposed paragraphs 15 and 16 and paragraphs BC32-BC34 of the Basis for Conclusions).
Are the proposed disclosures appropriate? If not, why not? Should additional disclosures be required? If so, what are they and why should they be required?

We believe the proposed disclosures to be appropriate and adequate. However, we suggest that the final IFRS should include illustrative examples of the disclosures required in order to encourage consistency of practice and enhance comparability.

We agree that exploration and evaluation expenditure incurred and recognised as an expense in the period should be disclosed. BC35 states that such disclosure is required under IAS 1 but this is not obvious from IAS 1 itself and the proposed IFRS should specify the paragraph in IAS 1 on which it is relying.

Should you wish to discuss this letter with us, please contact David Lindsell on 020 7951 4463.

Yours faithfully,

Ernst & Young