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Dear Sir David

Exposure Draft (ED) 6 *Exploration for and Evaluation of Mineral Resources*

We appreciate the opportunity to respond to the International Accounting Standards Board's exposure draft of its proposed IFRS *Exploration for and Evaluation of Mineral Resources*. This letter expresses the views of KPMG International on behalf of KPMG's member firms.

In ED 6 the IASB notes that the scope of several of its standards excludes certain activities of extractive industries entities. Because the Board is not able to complete a comprehensive project on extractive industry issues in the near term, it developed ED 6 to address exploration and evaluation activities, which are the concerns it identified as most pressing. In paragraph IN2 of ED 6 the Board notes its objective of providing guidance regarding these activities to enhance comparability while avoiding unnecessary disruption pending completion of a comprehensive project on extractive industries.

We support the IASB's objectives of minimising required changes in the short-term as extensive changes will be considered in any comprehensive project. However, we are concerned that ED 6 would not achieve the IASB's objective of limited improvements to accounting practices for exploration and evaluation (E&E) expenditures.

ED 6 proposes permitting an entity adopting IFRS under IFRS 1 *First-time adoption of international financial reporting standards* to continue to use current national GAAP policies regarding capitalisation or expensing of costs for E&E costs ("grandfathering" current GAAP for E&E expenditures). However, ED 6 explicitly prohibits grandfathering of current GAAP impairment tests. Instead ED 6 requires application of IAS 36 *Impairment of assets*, but permits an entity to use either a cash-generating unit (CGU) as defined in IAS 36, or a special CGU for E&E activities (CGU-EEA).

ED 6 reflects the Board's conclusion that this approach – grandfathering national GAAP capitalisation policies but not national GAAP impairment tests – achieves the right balance of minimising disruption and enhancing comparability. After discussion with those within KPMG who audit entities engaged in extractive industry activities, we have concluded that the proposals in ED 6 will not work. Therefore, we do not support finalisation of ED 6 in the form issued.

Our conclusion is that measurement of the recoverable amount of an asset, or of a group of assets, under IAS 36 during active pursuit of E&E activity is inconsistent with capitalisation of E&E costs. A standard that seeks to permit continuation of current national GAAP approaches to E&E expenditure should not apply IAS 36 until E&E activity largely has been completed, suspended or discontinued. Attempting to combine the permission proposed in ED 6 with IAS 36 will result in either (a) no meaningful ability to continue national GAAP practices of capitalisation of E&E expenditures if IAS 36 is applied in a way consistent with its application in other areas, as this is likely to require recognition of substantial impairment losses soon after capitalisation; or (b) applications of IAS 36 to capitalised E&E expenditures that are inconsistent with other applications of IAS 36.

Generally, IAS 36 only requires measurement of the recoverable amount if an indicator of impairment is present (see IAS 36.12-20). However, it is implicit in IAS 36 that whenever the recoverable amount is measured, any shortfall should be recognised as an impairment, even if the entity was not required to calculate the recoverable amount. In other words, an entity implicitly asserts that its assets are measured at an amount equal to or less than their recoverable amounts, on the basis that either it has no reason to believe that the carrying value is not recoverable, or that it has calculated the recoverable amount and compared that with the carrying value. For the reasons described below, an entity capitalising E&E expenditure could not make the same assertion that capitalised costs are recoverable as that term is used in IAS 36. Therefore, we believe that capitalisation of E&E expenditures cannot be integrated with IAS 36, with or without use of a CGU-EEA. This letter includes suggestions for alternative way to pursue the objectives identified for ED 6.

Inconsistencies between ED 6 and IAS 36

IAS 36 requires an entity to measure the recoverable value of an asset or group of assets whenever there is an indication that its carrying value may exceed its recoverable amount. IAS 36 defines recoverable amount as the higher of *value in use* and *fair value*. When calculating value in use, IAS 36 prohibits future cash flows from including future cash inflows or outflows related to future capital expenditure that will improve or enhance the asset (IAS 36.48), although estimates of outflows should include outflows expected to be incurred before the asset is ready for use or sale if the carrying amount of the asset does not include all costs to be incurred before the asset is ready for sale or use (IAS 36.49).

It is unclear how these requirements would apply to capitalised E&E costs. However, whether or not capitalised E&E expenditures are considered assets "under construction," the IAS 36 calculation of value in use does not fit well with capitalisation of costs during the E&E period.

- If capitalised E&E expenditures are considered to be an incomplete asset under development, then future cash outflows for exploration, and inflows from exploitation, presumably would be required to be included in a calculation of value in use. However, E&E activities generally are for sites where the potential future inflows are unknown; a key objective of E&E activity is to develop the assessment that would be the basis for such cash flow projections.

- If capitalised E&E expenditures are not considered assets under construction, then future exploration and development cash outflows, and related inflows, cannot be included in the projection of future cash flows, and the only possible cash flows from E&E expenditures would be on the basis of a possible sale of the data and field, area or interest in a property, in other words, the net selling price.

As a result, it appears that there would not be any meaningful value in use calculation that is both consistent with IAS 36 and could be made in respect of capitalised E&E expenditures. Therefore, application of IAS 36 would require measurement of recoverable amount based on net selling price. We have serious doubts as to whether there will be market-based information for the value of the E&E activity carried out to date before an assessment of the site has been substantially completed.

The inconsistency between (a) the stated objective of ED 6 to permit continuation of national GAAP practices of capitalisation of E&E expenditure and (b) application of IAS 36 is driven largely by the potential for IAS 36 to require measurement of the recoverable amount prior to the entity obtaining sufficient information to assess whether development of the site is warranted. In other words, the problem arises from measuring the recoverable amount before the E&E activity is complete or a decision is made to discontinue E&E activities.

Suggested modifications

Our conclusion is that, if the IASB wishes to permit continuation of national GAAP practices for capitalisation of E&E expenditures, then it should follow the approach taken in some national GAAPs regarding impairment during the period of active E&E activity. We suggest that the IASB pursue an approach that:

- permits continuation of national GAAP policies regarding capitalisation of E&E expenditure;

- requires measurement of the recoverable amount under IAS 36 when and only when (1) a decision has been made to discontinue exploration and evaluation; (2) a decision has been made to pursue development; (3) E&E activity largely has been suspended; or (4) in rare circumstances where sufficient data exists to indicate that, whilst a development is likely to proceed (and so E&E activity will continue), the recognised E&E asset is unlikely to be fully recoverable from a successful development or by sale; and

- provides guidance regarding when items (1)-(4), above, have been triggered.

We believe that the objective of enhancing comparability can be pursued at the same time by:

- addressing the types of costs that can be included in capitalised E&E expenditure (see ED 6.8(b)); and

- providing limited guidance, perhaps based on established national GAAPs, regarding the grouping of E&E activities and the level at which a decision is made regarding whether E&E is continuing (the trigger proposed above for measurement of recoverable amount under IAS 36).

In our view, focusing on these two aspects will be an approach that is more likely to achieve the objective of greater comparability. With respect to the second point -- providing guidance on grouping for application of impairment tests -- we believe that the IASB should *require* use of a CGU-EEA, rather than permitting it subject to certain conditions, as proposed in ED 6. However, the concept of a CGU-EEA will need to be modified to acknowledge that in many circumstances, there will not be any cash inflows which are capable of reliable measurement for E&E assets.

Under IAS 36, a CGU is defined as the "smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets." Discussions of ED 6 within KPMG member firms highlighted that, when this definition was applied to E&E activities, the CGU identified often would be at the same or higher level than the level defined by a CGU-EEA, as E&E activities are unlikely to generate largely independent cash flows individually. The discussion further identified that there will be many companies for which, no matter how high the level of aggregation of E&E assets, there will be no cash inflows generated pending completion of the evaluation of E&E and the decision to develop the property. This may in particular be the case for start up companies in the industry, for which E&E costs are likely to be the only substantial “asset” on the balance sheet, other than cash.

Within an entity that conducts E&E activities in several geographical areas, each one of which is treated as a segment for IAS 14 *Segment reporting* purposes, evaluation on a CGU-EEA basis would require assessment of completion (and, consequently, recoverable amount) within the geographic region. However, if an entity were not required to use a CGU-EEA, potentially it could group all of its E&E activities together and treat those as a single CGU. Therefore, we suggest *requiring* use of CGU-EEA, with that unit defined, as in ED 6, as being no larger than an IAS 14 segment, and not conditioning use of a CGU-EEA on a national GAAP impairment test having been applied to that grouping prior to adoption of IFRS.

Other comments

- ***Impairment indicators***

ED 6 proposes, in paragraph 13, adding six criteria to IAS 36 as possible indicators of impairment of capitalised E&E expenditures. Items (a)-(e) are useful indicators of when circumstances (1)-(4), described in "Suggested modifications" above, may have occurred, and we support requiring measurement of recoverable amount under IAS 36 in these circumstances. However, indicator 13(f), "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" could be used to trigger calculation of recoverable amount (and, most likely, recognition of an impairment loss) whenever an entity asserted that it had concerns about recoverability. Triggering calculation of recoverable amount, and therefore recognition of an impairment loss, is, in our view, inconsistent with permitting capitalisation of E&E expenditures while E&E activities are being pursued actively. Therefore, we suggest that the Board clarify this trigger and when it may apply. In our view, it should be limited to identified circumstances such as those in (4), above.

- ***Classification of capitalised E&E expenditures as tangible or intangible assets***

Paragraph 10 of ED 6 permits an entity to classify capitalised E&E expenditures as either IAS 16 *Property, plant and equipment* or IAS 38 *Intangible assets*, presumably based on the entity's current practice under national GAAP. We believe that the issue of whether capitalised E&E expenditures qualify for recognition as an asset, and, if so, the type of asset (tangible or intangible), are issues that should be addressed in the longer-term comprehensive project. We suggest that, in the meantime, the IASB consider requiring classification of capitalised E&E expenditures as tangible assets under IAS 16 in order to enhance comparability, particularly in light of recent interpretations to US SFAS 142 *Goodwill and other intangible assets* at the EITF meeting of 30 April which now indicates that mineral rights are to be treated as tangible assets under US GAAP. However, we believe that, for the reasons described in our comments regarding the difficulty of measuring recoverable amount under IAS 36, it will be very difficult to develop a meaningful fair value measurement for purposes of applying the revaluation model under IAS 16. Because any kind of cost-indexation approach, such as depreciated replacement cost, is of questionable value with respect to capitalised E&E expenditures, we suggest that the IASB prohibit use of the revaluation model in respect of capitalised E&E expenditures at least until the longer-term project is completed.

- ***Impairment testing of E&E costs in the opening IFRS balance sheet***

We do not believe that an entity adopting IFRS and electing to continue its previous national GAAP policy of capitalisation of E&E expenditures, subject to the limits in final IFRS, should be required to measure the recoverable amount under IAS 36 of costs in the opening balance sheet that are related to active E&E projects. Our concern is that this would result in recognising an impairment and introducing an inconsistency between the opening balance sheet and the accounting policy applied under both previous national GAAP and IFRS.

- ***Elements of E&E assets (par. 8)***

Paragraph 8 of ED 6 states that the development of a mineral resource once technical feasibility and commercial viability of extracting a mineral resource have been established shall not be included in the initial measurement of E&E assets. It is unclear what standard will apply to such development costs. On the one hand, these costs (appropriately) are excluded from capitalisation as E&E assets under ED 6. It also appears that they are outside the scope of IAS 38 and IAS 16 (see the proposed amendments to IAS 16 and IAS 38 in ED 6.B1-B2). However, development costs for proven reserves are likely to satisfy the Framework definition of an asset. We recommend that the IASB's redeliberation clarify what standard(s) should be applied to development costs.

- ***Measurement after recognition (par. 10)***

Paragraph 10 states that, after recognition, an entity shall apply either the cost model or the revaluation model (under either IAS 16 and IAS 38) to its E&E assets. The ability to revalue under IAS 38 is likely to be very limited or non-existent. IAS 38.75 requires fair value to be determined by reference to an active market. IAS 38.78 notes that it will be unusual for an active market to exist for an intangible asset, in part because items traded must be homogeneous, and E&E assets are not homogeneous as they relate to unique locations and interests. In order to avoid leaving a false impression that revaluation under IAS 38 is expected to be used, we suggest that the Basis of Conclusion reflect the Board's expectation if the Board permits capitalised E&E expenditures to be classified as intangible assets.

We also suggest noting how depreciation or amortisation of the capitalised E&E expenditures should be recognised. Where development of the resource continues rather than being sold or abandoned, it seems likely that any amortisation will be capitalised as part of the cost of the development of the field or mine. It would be helpful for implementation guidance to highlight this expectation.

- ***Business combinations and the consistency of accounting policies under IAS 27***

The limit on changing "grandfathered" E&E accounting policies may be difficult to apply to business combinations. Consider a situation in which a group applying the GAAP of country A (Group A) acquires a subsidiary that has been applying GAAP of country B (Sub B). The GAAP of country B is considered to be closer to the Framework and principles of IFRS than country A GAAP. Both the parent and the new subsidiary would comply individually with IFRS, but would be inconsistent with each other so that consolidation adjustments would be required by IAS 27 *Consolidated and separate financial statements* to align accounting policies of Sub B to those of Group A in the consolidated financial statements. If the Board wanted to permit Sub B to conform its separate entity accounting policies to those it used for group reporting purposes (and to avoid the need for such consolidated adjustments), it would be necessary to amend paragraph 11 of ED 6 to permit the new subsidiary to conform its accounting policies to those of its new parent, at least in these limited circumstances.

- ***Transition***

Discussions prompted by the development and publication of ED 6 have identified some differing views regarding which current national practices are consistent with the IFRS Framework and general principles. Some of these national practices may have been adopted by entities that already have adopted IFRS. We suggest that the Board not limit the application of a standard based on ED 6 to an entity that is a first-time adopter of IFRS. Instead, we encourage the Board to permit entities already reporting under IFRS to continue using current policies, subject to the limits in the final standard, even if, for example, recent changes to IFRS mean that these policies may not be viewed as continuing to be consistent with the IFRS Framework and general standards

Please contact Mark Vaessen at 020 7694 8089 or Mary Tokar at 020 7694 8288 if you wish to discuss any of the issues raised in this letter.

Yours faithfully

KPMG International

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Appendix – Responses to invitation to comment questions 1-5

Our responses (set out below) to the specific questions posed in the Exposure Draft are provided subject to our general concerns set out in our covering letter.

Question 1

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).

One current national GAAP accounting policy for exploration and development costs is the full cost method. Under this method, all exploration and development costs are accumulated in a single cost pool for all projects that share similar common characteristics, for example a geological area. Under this method costs are not necessarily segregated between E&E and development although in practice many companies will be able to do so. We presume that the intention of the Board is that any costs relating to the development phase of the extraction of the mineral reserve are accounted for either under IAS 38 or IAS 16. In some cases, there may be difficulty in separating out the two categories of cost on first application of a standard based on ED 6. The guidance on impracticability and retrospective application of new accounting policies in IAS 8 (2003) *Accounting policies, changes in accounting estimates and errors* does not appear to give specific guidance in relation to this issue. It would be helpful if the transitional provisions of the final standard provide some implementation guidance on the allocation between E&E on the one hand and further development expenditure on the other.

Furthermore, we believe that the standard should explain that expenditures incurred after the technical feasibility and commercial viability stage are development costs. In our view, these costs should be capitalised if they meet the criteria for capitalisation in either IAS 16 (eg as part of costs of a mine or well) or IAS 38 (as development).

As discussed in our main letter, based on ED 6.B1-B2, development costs will be excluded from the scope of both IAS 16 and IAS 38. The consequential amendments proposed in ED 6.B1-B2 should be revised so that development costs are within the scope of at least one of these two standards. Further, we note that the scope of IAS 16, as revised in December 2003, now excludes mineral reserves as well as mineral rights from its scope. Some questions have been raised as to whether this precluded classifying wells and mines as property, plant and equipment. In our view mines and wells should be recognised as property, plant and equipment.

We agree with the definitions of terms proposed in Appendix A. However, the Issues Paper *Extractive Industries* (November 2000) included within preproduction costs a distinction between pre-acquisition expenses and post-acquisition expenses. Under ED 6, it is not clear if the pre-acquisition expenses are included in the proposed definition of E&E assets. If pre-acquisition expenses are included in the proposed definition, conditions should be incorporated to determine if these expenses can be capitalised. These conditions could be similar to the conditions of the successful efforts method as referred to in the Issues Paper.

We suggest providing a clear definition of E&E activities and providing definitions of each of the specific expenditures identified in paragraphs 7(a)-(b). For example, “trenching” and “sampling” may not be commonly used terminology.

The IASB also should define “development costs” in order to avoid different interpretations, especially because it must be difficult to distinguish development costs from production costs for a developed field.

Question 2

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.*

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?

We agree with the approach of permitting an entity to continue to recognise and measure E&E assets in accordance with the accounting policies applied in its most recent annual financial statements.

As noted in our main letter, we suggest that the IASB require treating all capitalised E&E expenditures as fixed assets within the scope of IAS 16.

Question 3

[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 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?

As we noted in our main letter, we suggest that the IASB require use of a CGU-EEA without conditioning that on previous GAAP impairment tests.

In Appendix A to ED 6 the definition of a CGU-EEA refers to a segment, however segment is not a defined term either in ED 6 or in IAS 14. We presume that a segment is a reportable segment, however it would be helpful if the final standard clarified this.

We also are concerned that the definition of a CGU-EEA included in Appendix A automatically may become the whole of a reportable segment. We believe that such a definition may be too wide in some cases (eg entities currently using the successful efforts approach) and that a definition based on areas where the risks of success or failure are similar would be a more appropriate starting presumption. We agree that a CGU-EEA should be <u>no larger than</u> an IAS 14 reportable segment.

We agree that E&E assets should be subject to impairment testing but we do not agree with ED 6's proposal to require application of IAS 36 to capitalised E&E costs related to active E&E projects. As noted in our main letter, we suggest that the IASB develop limited guidance perhaps based on established national GAAPs regarding impairment testing of capitalised E&E expenditure. For example, under the full cost method as applied under some national GAAPs, entities must perform the "limitation on capitalised costs test" at each interim and annual balance sheet date to ensure that total costs capitalised do not exceed an expected recoverable amount whether or not indicators of impairment exist. Use of the full cost method is permitted implicitly by ED 6.12. If entities are permitted to use a full cost method under IFRS, we suggest including a requirement to perform a limitation on capitalised costs test at each interim and annual balance sheet date in the final standard.

In the absence of a clear definition of reserves, entities could use very different reserve quantities and probabilities to estimate future cash flows. IAS 36.33 allows an entity to consider budgets/projections that cover more than five years if it can be "justified". Due to the nature of extractive industries, entities may have cash flow forecasts based on reserve estimates that go far beyond the five-year threshold and fluctuate significantly depending on the production techniques utilised rather than a pre-determined growth rate. We assume that in this case the use of a period longer than five years can be justified.

Question 4

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?

As discussed in our main letter, we believe that the following trigger should be clarified:

"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 sales."

We believe that this trigger is likely to be breached in many if not most instances where a decision to move to development has not yet been made, as further work is required before such a decision can be made. On that basis, we believe that it will be difficult for entities to "expect to be reasonably capable". We believe that this could lead to a wide range of interpretations with some entities applying this at a very high level and hence not impairment testing many of these assets for impairment, whereas others may interpret this at a much lower level and hence perform many impairment tests, especially where it is perceived to be advantageous to write off some or all of the accumulated capitalised costs. Therefore, we described a suggestion for clarifying this trigger and when it may apply.

As discussed in our main letter, capitalised E&E expenditures in the opening balance sheet should not be tested for impairment under IAS 36 if E&E is being conducted.

We are of the view that there should not be a requirement to test capitalised E&E costs for impairment on initial adoption of IFRS unless a trigger such as those described in paragraph 13 a-e of ED 6 exists. Impairment testing (as distinct from reviewing for impairment indicators) would result in inconsistent existing accounting policies on transition compared to annual policies.

Question 5

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?

The disclosure requirements of ED 6 are appropriate. However, we do not see what could be disclosed as income as required by paragraph 16 (b) of ED 6.