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Colin Fleming
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31 August 2004

Subject: Elimination of Special Cash-Generating Unit in ***ED 6 Exploration for and Evaluation of Mineral Resources***

Dear Mr. Fleming,

As you requested in your e-mail of August 4, 2004, the information was forwarded to the Oil Industry Accounting Committee and I know they have prepared a comment letter to you on this subject.

We appreciate the opportunity to comment on the potential removal of the special cash-generating unit for impairment testing of exploration and evaluation assets bearing in mind that the original intention behind ED 6 was to allow existing accounting treatment to continue. We do not believe that this objective will be met with the proposed change to eliminate the special cash-generating unit, nor, if the special cash-generating unit was maintained and have included our reasons below.

We account for exploration and evaluation costs under the successful efforts method of accounting and capitalise such costs until it can be determined whether they have resulted in a commercial discovery for the Group. Under US GAAP, we are allowed to capitalise costs of drilling exploratory wells as a part of our uncompleted wells, equipment, and facilities <u>pending determination of whether the well has found proved reserves</u>. If the well has found proved reserves, the capitalised costs of drilling the well become part of our wells and related equipment and facilities. However, if the well has not found proved reserves, the capitalised costs of drilling the well will be charged to expense.

<u>Inherent difficulties for cash flow estimation</u>

Measurement of estimated cash flows is difficult for exploration and evaluation assets at the early stages of drilling. Until the asset has been evaluated, at times as part of a larger group of assets, it is impossible to estimate either cash inflows or outflows. The determination of estimated cash flows are required before it is possible to conclude the recoverable amount or to perform an impairment test if indicators are present. Since cash flows are directly linked to the production of reserves, the test prescribed under IAS 36 could have the unintended consequence of requiring the premature write-off of recoverable exploration assets.

<u>Impairment testing under US GAAP</u>

As noted above, US GAAP does not require these costs to be tested against recoverable cash flows until a well has found proved reverses. US GAAP, FAS 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, sets out the impairment assessment process required for exploration and evaluation assets in paragraphs 31 and 32. The US Standard allows under certain conditions and within a pre-defined time period these costs to remain capitalised until a determination about the commercial status of the well can be made.

This language is in line with the requirements of the IASB Framework and also with IAS 16, paragraph 7, which state the recognition criteria for an asset (i.e. the cost of an item of property, plant and equipment shall be recognised as an asset if, and only if: (a) it is probable that future economic benefits associated with the item will flow to the entity; and (b) the cost of the item can be measured reliably).

Determination of the cash-generating unit

Due to the nature of the majority of exploration and evaluation work currently undertaken, wells are generally not produced on an individual basis, but as part of a larger asset group. The costs/expenses related to the support facilities (platform, pipelines, etc.) are not allocated to a well level but are instead kept at a field level. Therefore, the requirements of paragraph 66 would be the field level, not the well level as indicated in the proposed revisions to the Exposure Draft. We feel that it is not possible to estimate the recoverable amount of the individual assets (i.e. wells), without making an arbitrary allocation of identifiable cash flows. Therefore the entity may determine the recoverable amount on the basis of a cash-generating unit to which more than a single well belongs (e.g. field).

Although an active market does exist for crude oil, the cash flow is not the result of the individual asset (i.e. well) but the group of assets that make up the infrastructure of the field. IAS 36, indicates that an active market may exist for a single asset or a cash-generating unit, and for exploration and evaluation costs, this is the field level. The use of the field level therefore is in line with the requirements of the standard.

As IAS 36, paragraph 69 also states it is important to consider other factors in determining a cash-generating unit – for example, how management monitors the entity's operations. For many oil and gas firms, this is at the field level not the well level.

Proposal

As noted in both the *July 2004 IASB Update* and also included in the *Effect of IASB Redeliberations* (paragraph 12) we were glad to see the Board's decision that an entity should assess an exploration and evaluation asset for impairment only when specific facts and circumstances indicate that the carrying amount of such an asset exceeds it recoverable amount. However, the Board's concerns for the application of IAS 36 *Impairment of Assets* for the determination of a cash-generating unit doesn't alleviate the particular problems related to exploration and evaluation assets.

We would like to propose that exploration and evaluation costs would be assessed for impairment (write-off) under our current oil and gas standards until the evaluation work is completed. Until this work is completed, there is no underlying cash generating unit at any level (well or field) on which to base an impairment test as outlined in IAS 36.

Once the determination of reserves has been made, we agree impairment testing of such assets would only be required if specific facts and circumstances indicated that the carrying amount of such assets exceeds its recoverable amount whether classified as tangible or intangible. Due to the fact that IAS 36 only discussed intangible assets not yet ready for use, we feel that it should be explicitly stated in the Exploration and Evaluation standard that the same test (specific facts or circumstances) should apply to either intangible or tangible assets. The impairment testing should be performed at the lowest level of identifiable cash flows without arbitrary allocations of revenues or costs.

The impact of this process will result in any unsuccessful well being expensed when it is determined that no commercial reserves have been found and for successful wells to be carried as part of the field level cash-generating unit and will be expensed as the revenues are earned. This treatment is the treatment that is used today for US GAAP successful efforts companies based on FAS 19. Without such a treatment, we feel the objective of the Exposure Draft, not to make any material changes to the way these costs are handled, will not be met.

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