IFRS

STAFF PAPER

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IASB Meeting

Project	**Extractive Activities**		
Paper topic	Asset measurement and impairment		
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Objective

1. Since issuing the 2010 *Extractive Activities* Discussion Paper (Discussion Paper), the Board has issued:

   (a) IFRS 13 *Fair Value Measurement* (June 2011);

   (b) amendments to IAS 36 *Impairment of Assets* (May 2013);

   (c) amendments to IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* (May 2014); and

   (d) *Conceptual Framework for Financial Reporting* (March 2018).

2. The purpose of this paper is to summarise what effect, if any, the issue of IFRS 13, amendments to IAS 16, IAS 36 and IAS 38 and the 2018 *Conceptual Framework for Financial Reporting* (2018 *Conceptual Framework*) have on the considerations and proposals in the Discussion Paper about asset measurement and impairment.

3. There are no questions for the Board in this Agenda Paper, but the staff would welcome any comments from Board members.

Overview

4. This paper is structured as follows:

(a) Summary (paragraphs 5–7);

(b) Background (paragraphs 8–17);

(c) Asset measurement (paragraphs 18–33);

(d) Impairment (paragraphs 34–37);

(e) Appendix A—Extracts from ***October 2010 Agenda Paper 7A Comment letter summary***.

Summary

5. Staff have considered the effect of new and amended IFRS Standards issued since 2010 together with the 2018 *Conceptual Framework*, on the considerations and proposals about asset measurement and impairment in the Discussion Paper.

6. The Discussion Paper primarily focused on analysing historical cost and fair value measurement bases and proposed historical cost be applied as the measurement basis. However, staff note that applying the 2018 *Conceptual Framework* a different measurement basis, or combination of measurement bases, might be identified as being more appropriate than historical cost. Alternatively, the 2018 *Conceptual Framework* might provide further support for historical cost as the measurement basis.

7. Staff have identified that one of the depreciation (or amortisation) considerations in the Discussion Paper (using revenue as a basis for depreciation or amortisation) may no longer be appropriate when applying paragraphs 62A of IAS 16 or 98A of IAS 38 (see paragraph 28).

Background

Asset measurement

8. In Chapter 4 of the Discussion Paper, the project team proposed that, on cost-benefit grounds, an entity's minerals and oil and gas properties should be measured at historical cost. To compensate for the apparent lack of useful information provided by this measurement, the project team also proposed that an

entity should provide detailed disclosure about those assets to enhance the relevance of the financial statements.

Impairment

9. The project team proposed that IAS 36 should not apply to properties in the exploration and evaluation phase. The team concluded that it would not be possible to make any reliable judgements that the carrying amount of any exploration property (ie the cost of the exploration rights and any subsequent exploration and evaluation activities) would be less than its recoverable amount until sufficient information is available to evaluate the exploration results and determine whether economically recoverable quantities of minerals or oil and gas have been found. Consequently, the project team proposed an alternative impairment approach in which management would:

(a) write down the exploration property only when, in its judgement, there is a high likelihood that the carrying amount will not be recoverable in full; and

(b) apply a separate set of indicators to assess whether the entity's exploration properties can continue to be recognised as assets.

Questions in the Discussion Paper

10. Questions 6 and 7 of the Discussion Paper asked respondents the following:

> **Question 6 – Minerals or oil and gas measurement model**
>
> Chapter 4 identifies current value (such as fair value) and historical cost as potential measurement bases for minerals and oil and gas properties. The research found that, in general, users think that measuring these assets at either historical cost or current value would provide only limited relevant information. The project team's view is that these assets should be measured at historical cost but that detailed disclosure about the entity's minerals or oil and gas properties should be provided to enhance the relevance of the financial statements (see Chapters 5 and 6).

In your view, what measurement basis should be used for minerals and oil and gas properties and why? This could include measurement bases that were not considered in the Discussion Paper. In your response, please explain how this measurement basis would satisfy the qualitative characteristics of useful financial information.

Question 7 – Testing exploration properties for impairment

Chapter 4 also considers various alternatives for testing exploration properties for impairment. The project team's view is that exploration properties should not be tested for impairment in accordance with IAS 36 *Impairment of Assets*. Instead, the project team recommends that an exploration property should be written down to its recoverable amount in those cases where management has enough information to make this determination. Because this information is not likely to be available for most exploration properties while exploration and evaluation activities are continuing, the project team recommends that, for those exploration properties, management should:

a) write down an exploration property only when, in its judgement, there is a high likelihood that the carrying amount will not be recoverable in full; and

b) apply a separate set of indicators to assess whether its exploration properties can continue to be recognised as assets.

Do you agree with the project team's recommendations on impairment? If not, what type of impairment test do you think should apply to exploration properties?

Summary of feedback received on the Discussion Paper

11. The following is a summary of the comment letter analysis which was presented to the Board in October 2010[1]. Extracts of the detailed comment letter analysis from October 2010 are located in Appendix A.

[1] See ***October 2010 Agenda Paper 7A***

Asset measurement

12. Almost all respondents agreed with the proposal to measure an entity's minerals or oil and gas properties at historical cost because it is a measure that:

(a) is verifiable;

(b) can be prepared in a timely manner; and

(c) can be used to assess financial performance and stewardship.

13. These respondents further explained that they did not support a fair value approach because it would introduce excessive subjectivity and short-term volatility to the financial statements. It would also impose significant preparation and audit costs which are not justified because users are not interested in that information.

14. A few respondents supported measuring minerals and oil and gas properties at fair value (or any other current value). These respondents explained that:

(a) valuation guidance and industry-specific guidance for mineral or oil and gas assets can be used to promote consistent preparation of those valuations; and

(b) in their view, insufficient research was undertaken on asset measurement alternatives in the project and that the user survey was biased towards sophisticated users that have the necessary time, expertise and information to make their own estimates of value. Consequently, measuring those assets at fair value should benefit those users that do not have the ability to conduct the same degree of analysis as the sophisticated users.

Impairment

15. Of those respondents that responded to this question, most opposed the project team's proposal for the following reasons:

(a) it would create an exception to IAS 36 (although a similar exemption exists currently in IFRS 6 *Exploration for and Evaluation of Mineral Resources*);

(b) it could overstate the exploration property in the statement of financial position and therefore also delay the recognition of an impairment loss; and

(c) there would be too much reliance on management judgement to identify when the carrying amount of the asset will not be recoverable in full. That could adversely affect comparability of financial statements.

16. Some respondents acknowledged the difficulty in applying IAS 36 to exploration properties because the specified indicators of impairment cannot be easily applied to them and there is often limited information available to reliably estimate their recoverable amount. Some of these respondents suggested that the Board review IAS 36 so that the Standard can be applied to those assets. A few respondents indicated that the Board should adopt a derecognition approach rather than an impairment approach for exploration assets.

17. More generally, some respondents remarked that the fact that IAS 36 is not considered to work for exploration assets may imply that the project team has proposed the wrong asset recognition approach.

Asset measurement

2018 Conceptual Framework for Financial Reporting

18. Historically, IAS 16, IAS 38 and IAS 40 *Investment Property* provided a choice of measurement models to apply. The 2010 *Conceptual Framework* also provided limited guidance on measurement bases. However, 'Chapter 6—Measurement' of the 2018 *Conceptual Framework* describes various measurement bases and discusses factors to be considered when selecting a measurement basis.

19. In particular, the 2018 *Conceptual Framework* identifies only the following measurement bases for assets:

(a) historical cost—provides monetary information about assets, liabilities and related income and expenses, using information derived, at least in part, from the price of the transaction or other event that gave rise to them;

(b) fair value (current value)—the price that would be received to sell an asset, or transfer a liability, in an orderly transaction between market participants at the measurement date;

(c) value in use (current value)—value in use is the present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal; and

(d) current cost (current value)—the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date plus the transaction costs that would be incurred at that date.

20. The 2018 *Conceptual Framework* goes further to state that when selecting a measurement basis, it is important to consider the nature of the information that the measurement basis will produce in both the statement of financial position and the statement(s) of financial performance, as well as other factors discussed in paragraphs 6.44–6.86 in the 2018 *Conceptual Framework* (in particular, see paragraphs 6.23 and 6.43 of the 2018 *Conceptual Framework*).

21. The 2018 *Conceptual Framework* also provides additional guidance on what to consider when selecting an appropriate measurement basis (or bases):

(a) information provided by particular measurement bases (paragraphs 6.23–6.42 of the 2018 *Conceptual Framework*); and

(b) factors to consider when selecting a measurement basis (paragraphs 6.43–6.86 of the 2018 *Conceptual Framework*).

22. Paragraphs 6.55–6.56 and 6.60–6.62 of the 2018 *Conceptual Framework*, which provide guidance on how a resource produces cash flows and how uncertainty affects the choice of measurement basis, are particularly pertinent and would need to be considered further in selecting an appropriate measurement basis. In addition, considering paragraph 6.64 and how cost constrains the selection of a particular measurement basis will also be important in light of the feedback to the Discussion Paper in paragraph A4 of Appendix A.

23. The 2018 *Conceptual Framework* also clarifies that, in some cases, more than one measurement basis is required for an asset or liability and for related income and

expenses in order to provide relevant information that faithfully represents both the entity's financial position and its financial performance.

24. Consequently, the additional guidance in the 2018 *Conceptual Framework* may support the conclusions of the Discussion Paper, or may result in reaching alternative conclusions about an appropriate measurement basis, or combination of measurement bases, for the measurement of minerals or oil and gas properties. This is because:

    (a) the needs of users of financial statements may have changed since 2010 affecting what information is considered relevant; and

    (b) the conditions within the industry may have changed such that information produced by other measurement bases could be concluded to be more faithfully representative of an entity's financial position and financial performance.

25. The Discussion Paper considered only two potential measurement bases for minerals and oil and gas properties in detail:

    (a) historical cost (see paragraphs 26–28); and

    (b) fair value (see paragraphs 29–33).

Historical cost

26. Paragraph 4.4 of the Discussion Paper explains that historical cost is most commonly used by entities in the extractives industry to measure minerals or oil and gas properties. In particular, two specific variations of historical cost—successful efforts accounting and full cost accounting—have been developed for the oil and gas industry. A further variant of historical cost—area of interest accounting—is also prevalent in the minerals industry.

27. Paragraphs 4.44–4.49 of the Discussion Paper explain historical cost measurement after initial recognition and approaches to depreciating (or amortising) exploration properties and minerals or oil and gas properties that have been recognised as assets. In particular, these approaches related to the determination of depreciation (or amortisation) on a units of production basis for minerals or oil and gas properties, including:

(a) whether the units of production formula should be based on revenue (such as gross revenue) or physical units (which, particularly in the minerals industry, could either be the ore produced or the mineral contained in the ore produced);

(b) whether the units of production formula should be calculated on proved reserves only or on the sum of proved and probable reserves, or potentially also include some resources classifications if it is expected that future development will take place at the mine or field; and

(c) how to apply units of production depreciation (or amortisation) when more than one commodity is extracted from the same property.

Amendments to IAS 16 Property, Plant and Equipment *and IAS 38* Intangible Assets

28. In May 2014 the Board amended IAS 16 and IAS 38 to prohibit the use of a revenue-based depreciation or amortisation method. Paragraphs 62A of IAS 16 and 98A of IAS 38 explain that a depreciation or amortisation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate. The revenue generated by an activity that includes the use of an asset generally reflects factors other than the consumption of the economic benefits of the asset. Consequently, it may no longer be appropriate to determine depreciation or amortisation based on revenue as considered in the 'units of production formula' when applying paragraphs 62A of IAS 16 or 98A of IAS 38 (see paragraph 27(a)).

Fair value

29. The Discussion Paper also considered fair value as a potential alternative to historical cost because it was concluded that the identified users of financial statements would be most interested in:

(a) estimating the value of the entity—the value of an entity's properties that contain minerals or oil and gas reserves is generally the most substantial part of this estimate for upstream minerals or oil and gas entities; and

(b) whether the future cash flows that are expected to be generated from the entity's properties will be sufficient for the entity to meet its obligations.

30. The Discussion Paper considered three approaches to estimating fair value for minerals and oil and gas properties after recognition:

(a) market approach (see paragraph 4.12 of the Discussion Paper)—this approach uses prices and other relevant information generated in market transactions involving identical or comparable assets. However, the uniqueness of mineral or oil and gas properties means that deriving fair value for these properties only by reference to market transactions is rarely possible;

(b) cost approach (see paragraph 4.13 of the Discussion Paper)—this approach is based on the amount that would currently be required to replace the service capacity of an asset. However, this approach is generally not suitable for minerals or oil and gas properties because each property is unique; and

(c) income approach (see paragraphs 4.14–4.22 of the Discussion Paper)—this approach calculates fair value by discounting estimated future cash flows. This approach is most commonly used by those entities applying a fair value measurement basis for investment decision-making for their minerals or oil or gas properties.

31. While paragraph 6.12 of the 2018 *Conceptual Framework* defines fair value as 'the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date', paragraph 6.14 states that fair value can also be determined indirectly using measurement techniques reflecting all the following factors:

(a) estimates of future cash flows;

(b) possible variations in the estimated amount or timing of future cash flows for the asset or liability being measured, caused by the uncertainty inherent in the cash flows;

(c) the time value of money;

(d) the price for bearing the uncertainty inherent in the cash flows (a risk premium or risk discount); and

(e) other factors, for example, liquidity if market participants would take those factors into account in the circumstances.

IFRS 13 Fair Value Measurement

32. In considering a fair value approach for asset measurement in the Discussion Paper, the project team applied the principles in the 2009 Exposure Draft *Fair Value Measurement*.

33. Consequently, the approaches to the measurement of minerals or oil and gas properties at fair value after recognition that are summarised in paragraph 30 remain consistent with the 2018 *Conceptual Framework* and the requirements of IFRS 13.

Impairment

34. Paragraphs 4.50–4.59 of the Discussion Paper explain the application of IAS 36 to exploration, minerals or oil and gas properties and the associated issues identified as part of the November 2000 *Summary of Issues: Extractive Industries*. The project team noted that applying the impairment model in IAS 36 to exploration properties might not be appropriate because of the lack of relevant information needed to determine a 'recoverable amount' for exploration properties.

35. Accordingly, paragraphs 4.60–4.72 of the Discussion Paper detail alternatives to applying IAS 36 to exploration properties, in particular:

(a) option A—revisiting the project team's view on initial recognition in Chapter 3 of the Discussion Paper to require instead that exploration and evaluation costs are recognised as expenses as incurred until sufficient information is obtained to indicate the existence of economically recoverable reserves;

(b) option B—allowing entities to recognise an impairment loss for an exploration property without having to determine recoverable amount in cases in which determining that amount would involve undue cost or effort; or

(c) option C—identifying indicators of impairment that are different from those in IAS 36 and apply specifically to exploration properties.

Amendment to IAS 36 Impairment of Assets

36. In May 2013 IAS 36 was amended by *Recoverable Amount Disclosures for Non-Financial Assets* (Amendments to IAS 36). The amendments require the disclosure of information about the recoverable amount of impaired assets, if that amount is based on fair value less costs of disposal, and the disclosure of additional information about that fair value measurement.

37. The amendment to IAS 36 does not affect the project team's alternatives to applying IAS 36 summarised in paragraph 35. The project team's considerations remain consistent with IAS 36.

Appendix A—Extracts from *October 2010 Agenda Paper 7A Comment letter summary*

Measurement

A1. The topic of measurement of a minerals or oil and gas property has been a controversial topic throughout the research project. The research considered fair value (or another form of current value) and historical cost as potential measurement bases for those assets. Prior to reaching a view, the project team completed an extensive survey of sell-side and buy-side analysts, lenders and analysts from credit rating agencies, and venture capitalists to obtain their views on the design of a future accounting and disclosure model for extractive activities, with particular attention placed on asset measurement.

A2. The research did not find substantive support for measuring minerals or oil and gas properties at fair value or at historical cost:

(a) users indicated that the historical cost of those assets would provide limited useful information and that information would typically only be used to assess the stewardship of management. To be useful for that purpose, the capital that the entity has invested in extractive activities would need to be included in the carrying amount of the corresponding assets. Consequently, a historical cost measure would have limited usefulness for that purpose if, for instance, an entity's accounting policy is to recognise some (or all) of its exploration and evaluation costs as expenses when incurred.

(b) users indicated that they would only make limited use of an estimate of the fair value (or any other current value) of those assets. Those users expressed concerns that an entity-prepared fair value measurement of those assets would not be representationally faithful because of the subjectivity and degree of estimation involved in preparing those estimates.

A3. Based on those findings, the project team recommended that, on cost-benefit grounds, an entity's minerals or oil and gas properties should be measured at historical cost. To compensate for the apparent lack of useful information provided by asset measurement, the project team also recommended that an entity should provide detailed disclosure about those assets to enhance the relevance of the financial statements.

A4. Almost all respondents agreed with the proposal to measure the assets at historical cost because it is a measure that is verifiable, can be prepared in a timely manner, and it can be used to assess financial performance and stewardship. Those respondents explained that they did not support a fair value approach because it would introduce excessive subjectivity and short-term volatility to the financial statements, and it would impose significant preparation and audit costs which are not justified because users are not interested in that information. For example:

We do not believe a fair value measurement model would be practical or cost-beneficial due to the following reasons:

- *Fair value information is not readily available;*
- *Oil and gas properties include a number of unproved properties and properties with contingent resources, for which estimating fair value would be a very complex and costly process and the resulting fair value estimate would be very subjective;*
- *Given the number of unproved properties, reserve pools and production facilities in the Canadian oil and gas industry and the lack of qualified independent valuators, establishing fair values for all these assets at a point in time for quarterly or year-end reporting and auditing purposes is near, if not totally, impossible;*
- *In the absence of independent valuations, use of valuations determined by management would become a significant audit verification issue;*
- *Many users would not place much reliance on company specific models and would use their own models to determine the estimated "fair value" of a company's reserves;*
- *Disclosure of the calculated fair value information may no longer be relevant by the time it is actually released publicly;*
- *The oil and gas industry is particularly susceptible to wide fluctuations in commodity prices due to the significant amount of natural gas, heavy oil and bitumen produced, all of which are subject to seasonal commodity price swings. Impairment write-downs and subsequent recoveries would be common given even modest changes in oil and gas commodity prices;*
- *Such volatility in fair values would negatively affect the comparability of oil and gas entities and reduce clarity and usefulness of the financial and reserves information to the users;*
- *Many different market participant assumptions will be used in determining and assigning fair value by individual companies. This would impair comparability across companies; and*

- *Disclosure of fair value information may require company sensitive information to be included. (CL#36)*

A5. Very limited support was expressed for measuring minerals or oil and gas properties at fair value (or any other current value). A respondent explained that valuation guidance such as International Valuation Standards and industry-specific valuation guidance for mineral assets could be used to promote consistent preparation of those valuations. Another respondent was concerned that insufficient research was undertaken on asset measurement alternatives and that the user survey was biased towards sophisticated users that have the necessary time, expertise and information to make their own estimates of value. That respondent suggested that measuring those assets at fair value should benefit other users that do not have the ability to conduct the same degree of analysis as the sophisticated users.

A6. Several respondents also remarked that the main criticism of historical cost measures, which is that there may be little or no relationship between the costs of the activity and the future cash flows generated, is not unique to the extractive industries. Consequently, they suggested that those criticisms should not be addressed for individual topics at this time. A typical comment was:

> *…we believe the IASB should consider the appropriate measurement basis for financial reporting generally as part of their deliberations on the Framework. Until such time that a current value/fair value measurement basis is determined to be the appropriate measurement basis for financial reporting generally, we do not believe it would be appropriate to impose such a measurement model on entities engaged in extractive activities. (CL#111)*

Impairment

A7. Of those respondents that responded to this question, most opposed the project team's proposal for the following reasons:

(a) it would create an exception to IAS 36 (although a similar exemption exists currently in IFRS 6);

(b) it could overstate the exploration property in the statement of financial position and therefore also delay the recognition of an impairment loss; and

(c) there would be too much reliance on management judgement to identify when the carrying amount of the asset will not be recoverable in full. That could adversely affect comparability of financial statements.

A8. Some respondents acknowledged the difficulty in applying the IAS 36 approach to assets such as exploration properties because the specified indicators of impairment cannot be easily applied to them and there is often limited information available to reliably estimate their recoverable amount. Some of those respondents suggested that the Board review IAS 36 so that the Standard can be applied to those assets. Others indicated that the Board should adopt a derecognition approach rather than an impairment approach for these assets.

A9. More generally, some respondents remarked that the fact that the IAS 36 impairment test approach is not considered to work for these assets may imply that the project team has proposed the wrong asset recognition approach.