

IASB EMERGING ECONOMIES GROUP

DRAFT PAPER ON ACCOUNTING FOR EXTRACTIVE ACTIVITIES

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**Financial Reporting Standards Council of South Africa (FRSC)
In conjunction with
The Accounting Practices Committee (APC) of The South African
Institute of Chartered Accountants (SAICA)**

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Introduction

1. This paper is intended to deal with the initial recognition of costs incurred in the processes engaged in by reporting entities conducting extractive activities as well as certain of the initial and subsequent measurement issues encountered, but also what disclosures should be mandated when reporting in terms of IFRS.
2. IFRS 6 - *Exploration for and Evaluation of Mineral Resources* does not provide sufficient guidance for entities to report on a consistent and comparable manner, something that the FRSC believes is absolutely imperative for IFRS.
3. This paper explores some options which need to be considered in deciding on the scope for a future project on extractive activities that will assist to put all IFRS reporters on the same playing field, it also includes several questions on these proposals and would appreciate any feedback.
4. The purpose of this paper is for it to be deliberated on by the EEG to ultimately come up with a scoping proposal for a research project on extractive activities

Background

5. In 2004, the International Accounting Standards Board (IASB or Board) constituted an international project team comprising staff from the national standard-setters in Australia, Canada, Norway and South Africa to research the accounting for extractive activities. The IASB discussion paper ('DP') issued in April 2010, presented that project team's findings and recommendations as a result of that research. The Board discussed the project team's proposals at the October 2010 IASB Board Meeting together with the comments received. At that meeting, the Board did not make any decisions. At the time, the IASB regarded extractive activities research project as completed. Therefore, any subsequent decisions on extractive activities would be made only within the context of developing a possible future agenda proposal.
6. Since the above an Interpretation, IFRIC 20 – (Stripping Costs in the Production Phase of a Surface Mine), was issued to assist entities in accounting for stripping costs. This interpretation has a very limited scope in terms of assisting only entities that are engaged in surface mining and does not assist entities in the phases of extractive activities before production has commenced.
7. The IASB has also added extractive activities project with the Intangible Assets and Research and Development projects on its long-term research projects.
8. The FRSC has been requested to present a paper on extractive activities to the Emerging Economies Group of the IASB (EEG) at their next meeting to be held in December 2014.

Scope and Approach

9. The scope of the 2010 DP on extractive activities project was defined by its objectives, which was:
 - a) to analyse the unique financial reporting issues applicable to extractive activities in the mining and oil & gas industries; and
 - b) to identify a basis on which a financial reporting model might be developed to address them.
10. The project objective emphasised that the research should only consider financial reporting issues that can be regarded unique to extractive activities. The purpose of specifying the project's scope in those terms was to clarify that the scope would not extend to developing industry-specific solutions to financial reporting issues that also exist in other industries.
11. Some respondents recommended that the Board should provide guidance on specific application issues that arise in applying IFRS to arrangements, transactions and events that are prevalent, but not necessarily restricted to, the extractive industries.
12. The purpose of this paper is to guide a discussion on options for a research project on extractive industries with a view to develop a scope for such research. Once the scope of the project is finalised, a research project on extractive activities will follow.
13. This paper thus sets some of the issues facing extractive activities and the available options to exploring how to develop a standard or update existing standards to come up with an accounting solution to the accounting challenges faced by companies in extractive activities.
14. In response to the IASB's DP in 2010, respondents identified various alternatives for defining the scope of a future project on extractive activities. The staff paper to the DP noted that 'any future decision to add a project to the Board's agenda will follow the public consultation on the agenda and consideration of a detailed project proposal. At the IASB meeting held in October 2010, the IASB staff presented the DP and possible approaches that the project on extractive activities could take. These can be set-up broadly in 2 approaches:
 - (a) undertake a specific project for extractive activities; or
 - (b) undertake a project that would treat extractive activities consistently with activities conducted in other industries, such as research and development activities in the pharmaceutical or high-tech industries

View A – Undertake a specific project for extractive industries

15. Under this view respondents identified the following project scope alternatives for the development of specific requirements for extractive activities:
 - (a) a single IFRS that would apply to extractive activities in both the minerals industry and the oil & gas industry; or
 - (b) separate IFRSs for extractive activities in the minerals industry and also a separate standard for extractive activities in the oil & gas industry.

16. As noted in paragraph 11 of the DP, the proponents of a single IFRS agreed with the project team's conclusion that extractive activities in the minerals industry and in the oil & gas industry are sufficiently similar to justify the development of a single standard. They also concurred with the project team's observation that some of the traditional differences between operations in the minerals industry and oil & gas industry (such as the relative risks and uncertainties attributable to exploration and development activities in each industry) are becoming less significant, particularly as the oil & gas industry is increasingly focused on 'unconventional' projects (e.g. deep water oil & gas fields, extraction of oil sands, etc).
17. This was emphasised in the IASB 2010 Staff Paper presented as part of the 2010 DP. The respondents for this view proposed that a single standard for extractive activities should be developed. The project team's view was that users of the financial statements should have access to comparable information regardless of whether they are involved in minerals or oil and gas industries. The project team acknowledged that this objective could be met by developing a common, but not necessarily identical, set of requirements. If necessary the detail of those requirements could be tailored for minerals and oil and gas.

Question 1

Do you agree that a specific project for extractive industries should be undertaken? If so, do you agree that a single IFRS for extractive activities should be developed?

18. However, as per paragraph 12 of the DP, proponents of separate IFRSs argued that many extractive activities in each industry are not comparable because those activities are subject to different risks and uncertainties.
19. For example, the different physical properties of minerals (i.e. solids, and therefore cannot move) and oil & gas (i.e. typically fluid, and therefore can flow) means that the processes for evaluating estimates of recoverable quantities of minerals or oil & gas will be different and the risks and uncertainties associated with the extraction of those quantities will also be different. Consequently, those respondents were concerned that a 'one size fits all' approach for extractive activities would not necessarily provide users with useful information on an entity's assets and on the results of its activities.

View B - Undertake a project that would treat extractive activities consistently with activities conducted in other industries, such as research and development activities in the pharmaceutical or high-tech industries

20. Respondents challenged the presumption in the DP that a separate IFRS should be developed for extractive activities. Those respondents considered that:
- a) extractive activities are sufficiently similar to activities undertaken in other industries, especially research & development activities in the pharmaceutical and high technology industries; and
 - b) to develop a separate standard (or standards) on extractive activities would be inconsistent with the Board's philosophy of developing standards that are both principle-based and not industry-specific.
21. We propose that the EEG should deliberate these options with a view to narrow the options to a workable solution:
- One option is the development of industry specific IFRSs

- The second approach, that is, accounting for extractive activities should be treated in same manner as activities conducted in other industries, for example, research and development activities in the pharmaceutical or high-tech industries. This is further supported by the comparison that has been performed below to illustrate the differences and similarities between oil and gas, mining, and. pharmaceutical industries.

22. Comparison between the oil and gas, mining, and. pharmaceutical industries

<u>Life cycle</u>	<u>Oil and Gas¹</u>	<u>Mining²</u>	<u>Pharmaceuticals³</u>
<i>Exploration</i>	<p>Description:</p> <p>Exploration costs are incurred to discover hydrocarbon resources.</p> <p>Exploration starts when the legal rights to explore have been obtained.</p>	<p>Description:</p> <p>Exploration' means the search for resources suitable for commercial exploitation. It includes:</p> <ul style="list-style-type: none"> • researching and analysing an area's historic exploration data; • conducting topographical, geological, geochemical and geophysical studies; and • exploratory drilling, trenching and sampling. 	<p>Description:</p> <p>Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.</p> <p>Examples of research activities are:</p> <p>(a) activities aimed at obtaining new knowledge;</p> <p>(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;</p> <p>(c) the search for alternatives for materials, devices, products, processes, systems or services; and</p> <p>(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.</p>
<p>Summary:</p> <p>There is no distinct difference between exploration and research as defined in IAS 38 – <i>Intangible</i></p>			

¹ PwC Financial reporting in the oil and gas industry, International Financial Reporting Standards, 2nd Edition, September 2011

² PwC Financial reporting in the mining industry, International Financial Reporting Standards, 6th Edition, November 2012

³ IAS 38 *Intangible Assets*

Assets. That being said, research includes exploration. Under IAS 38 the cost relating to the research phase are being expensed as incurred.

<p><i>Evaluation activities</i></p>	<p>Description:</p> <p>Evaluation costs are incurred to assess the technical feasibility and commercial viability of the resources found</p>	<p>Description:</p> <p>Evaluation' means determining the technical feasibility and commercial viability of a mineral resource. It includes:</p> <ul style="list-style-type: none"> • assessing the volume and grade of deposits; • examining and testing extraction methods and metallurgical or treatment processes; and • surveying transportation and infrastructure requirements; and • conducting market and finance studies. <p>The evaluation stage usually produces a feasibility study that identifies proved or probable reserves and leads to a decision to develop a mine</p>	<p>Description:</p> <p>Refer to the above – IAS 38 provides an example that the research phase includes the evaluation and final selection of, applications of research findings or other knowledge. Hence research as defined in IAS 38 is much broader and includes both exploration and evaluation.</p>
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Summary:

As noted above, the research phase as defined in IAS 38 is much broader and includes both exploration and evaluation. It should be noted that costs incurred in this phase under IAS 38 are expensed as incurred. Given the fact that IFRS 6 – *Exploration for and Evaluation of Mineral Resources* is silent on whether these costs should be expensed or capitalised, the same would be available under the IFRS 6. One thing to note is the fact that, normally after the exploration and evaluation or research stages, a feasibility study is produced that identifies the economic viability of the project/undertaking.

<p><i>Development activities</i></p>	<p><u>Description:</u></p> <p>Development expenditures are costs incurred to obtain access to prove reserves and to provide facilities for extracting, treating, gathering and storing the oil and gas.</p>	<p><u>Description:</u></p> <p>Development means establishing access to and commissioning facilities to extract, treat and transport production from the mineral reserve, and other preparations for commercial production. It may include:</p> <ul style="list-style-type: none"> • sinking shafts and underground drifts; • permanent excavations; • constructing roads and tunnels; and • advance removal of overburden and waste rock. 	<p><u>Description:</u></p> <p>Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.</p>
<p><u>Summary:</u></p> <p>As noted above, no difference have been noted as the expenditures are incurred after feasibility have been completed and before the commencement of commercial production. Consideration should however be given to the fact that there is no bright line between research and development and judgement should be applied. Therefore, it raises the question as to whether IAS 38 is the right place to find guidance on said matter. Although the standard provides some guidance the dividing line between research and development is still notoriously elastic.</p>			
<p><i>Production activities</i></p>	<p><u>Description:</u></p> <p>Midstream and downstream activities in the oil and gas industry include the transportation of crude oil and gas, the refining of crude oil and the sales of the refined products. This part of the value chain is also dependent on significant capital investment. This includes refineries, liquefied natural gas (LNG) facilities, pipeline networks and retail stations.</p>	<p><u>Description:</u></p> <p>Production means the day-to-day activities of obtaining a saleable product from the mineral reserve on a commercial scale. It includes extraction and any processing before sale.</p>	<p><u>Description:</u></p> <p>The production process includes the day-to-day activities of obtaining a saleable product from raw materials, labour and production overheads.</p>

	Integrated oil and gas companies may also have divisions that perform speculative trading of oil and gas		
<p>Summary:</p> <p>The production of minerals and the production of goods follow the same process. There are some unique sector wide accounting issues such as inventory valuation, etc. but the process in the value chain is the same and includes the commercial production of items before sale.</p>			

Question 2

Do you agree with the view that extractive activities are sufficiently similar to activities undertaken in other industries, for example, the research and development activities in the pharmaceutical or high-tech industries?

23. From this approach the following scope applications were suggested:
 - (a) undertake a broader scope review of intangible assets guidance, including specific consideration of the accounting for and disclosure of extractive activities;
 - (b) undertake a limited scope project to revise existing IFRSs such that they can apply to extractive activities and to consider any inconsistencies with the *Conceptual Framework*.
 - (c) undertake a project for all aspects of extractive activities not covered by the first 2 approaches above.
24. Based on the IASB Work Plan it is noted that it would appear that the IASB has decided to follow the first scope application.
25. The EEG should consider whether clarity in accounting for extractive activities is needed more urgently due to the fact that several jurisdictions with significant extractive activities have adopted IFRS in the recent past. The lack of guidance and clarity is forcing these jurisdictions to effectively fall back on their previous GAAP applications and although this would be acceptable in terms of IFRS 6, the policies might be significantly divergent from jurisdictions that have developed practises/policies over time with the development of IFRS.
26. Our intention is to use this paper and the staff papers on the 2010 DP to consider scoping for a future extractive industries project and to identify issues that are currently being experienced and to try and apply existing IFRS to deal with these issues, or to propose where such issues are not being consistently applied using current guidance to request the IFRS Interpretation Committee to consider these issues as part of its agenda and request the IASB to consider issues that could be resolved via limited amendments to IFRS.

27. The EEG should determine whether it believes this approach would greatly enhance the IASB's position in achieving its objectives of providing consistent and comprehensive guidance for extractive activities.
28. This paper would broadly follow the flow of the IASB discussion paper as most of the issues being faced by entities engaged in extractive activities have been included in the discussion paper, except for some which were later resolved, e.g. Stripping Costs in the Production Phase of a Surface Mine. The first outcome of this paper will be agreement on the scope of the extractive industries project.

Question 3

Of the three approaches outlined in paragraph 23, which one do you support and why do you support it?

Other considerations

29. The following additional information should be considered as part of the standard setting process:
 - (a) risk-sharing arrangements and conveyances, such as
 - (i) farm-in/farm-out agreements;
 - (ii) production sharing agreements;
 - (iii) carried interests; and
 - (iv) unitisations;
 - (b) difficulties in applying IFRSs to assets that are simultaneously in development and production, such as:
 - (i) production stripping costs (which are currently being considered by the IFRS Interpretation Committee); and
 - (ii) calculating 'value in use' under IAS 36;
 - (c) accounting for government imposts (e.g. resource rent taxes, royalties, production sharing arrangements);
 - (d) inventory stockpiles; and
 - (e) accounting for the underlift or overlift balances of oil & gas.

Question 4

4.1 Do you agree that the considerations listed above should be considered as part of the standard drafting process?

4.2 Do you have any other considerations?

Specific application issues

Asset Recognition

30. Due to the current requirements of IFRS 6 which were developed as an interim measure to allow (with some limitations) entities adopting IFRS to continue to apply their existing accounting policies for expenditures incurred during the evaluation and exploration phases, much diversity in practice is being experienced. This is a result of the absence of a comprehensive IFRS literature in the international financial reporting for extractive activities. Therefore, concerns have also been raised that some accounting practices might not be consistent with the *Conceptual Framework for Financial Reporting*.
31. This would be highlighted by a new start-up entity that comes into existence. This entity would not have a previous accounting policy and would thus then look at its peers to identify which policy to apply. In this analysis it would see a large array of accounting policies being applied. The same could be said for investors needing to evaluate the performance and financial position of entities conducting the same activity in the same jurisdiction, their accounting policies could be vastly different.
32. Below are examples of accounting policies to illustrate the diversity

Examples of accounting policies:

Capitalisation of exploration property acquisition costs

Anglo American Plc

Exploration and evaluation expenditure is expensed in the year in which it is incurred. When a decision is taken that a mining property is economically feasible, all subsequent evaluation expenditure is capitalised within property, plant and equipment including, where applicable, directly attributable pre-production development expenditure. Capitalisation of such expenditure ceases when the mining property is capable of commercial production.

Exploration properties acquired are recognised in the balance sheet at cost less any accumulated impairment losses. Such properties and capitalised evaluation and pre-production development expenditure prior to commercial production are assessed for impairment in accordance with the Group's accounting policy stated above.

Extract from annual report and accounts 2011, Anglo American Plc, p. 131

BDO - SAMPLE PRECIOUS & OTHER METALS EXPLORATION CORPORATION ILLUSTRATIVE IFRS FINANCIAL STATEMENTS

Once the legal right to explore a property has been acquired, costs directly related to exploration and evaluation expenditures (E&E) are recognized and capitalized, in addition to the acquisition costs. These direct expenditures include such costs as materials used, surveying costs, drilling costs, payments made to contractors and depreciation on plant and equipment during the exploration phase. Costs not directly attributable to exploration and evaluation activities, including general administrative overhead costs, are expensed in the year in which they occur.

Extract from Illustrative IFRS Financial Statements 2012, Note 2 d) p. 9 of 31

China Coal Energy Company Limited Exploration and evaluation expenditure

During the initial stage of a project, exploration and evaluation costs, other than costs incurred in acquiring land use and mining rights, are expensed as incurred.

Expenditure on a project after it has reached a stage at which there is a high degree of confidence in its viability is capitalised and transferred to property, plant and equipment if the project proceeds. If a project does not prove viable, all irrecoverable costs associated with the project are expensed in the income statement.

Extract from annual report and accounts 2011, China Coal Energy Company Limited, p. 128

Impala Platinum Holdings Limited

The Group expenses all exploration and evaluation expenditures until the directors conclude that a future economic benefit is more likely than not of being realised, i.e. probable. In evaluating if expenditures meet this criterion to be capitalised, the directors utilise several different sources of information depending on the level of exploration. While the criteria for concluding that expenditure should be capitalised is always the “probability” of future benefits, the information that management use to make that determination depends on the level of exploration.

- *Exploration and evaluation expenditure on greenfields sites, being those where the Group does not have any mineral deposits which are already being mined or developed, is expensed as incurred until a final feasibility study has been completed, after which the expenditure is capitalised within development costs, if the final feasibility study demonstrates that future economic benefits are probable.*
- *Exploration and evaluation expenditure on brownfields sites, being those adjacent to mineral deposits which are already being mined or developed, is expensed as incurred until management are able to demonstrate that future economic benefits are probable through the completion of a prefeasibility study, after which the expenditure is capitalised as a mine development cost. A ‘prefeasibility study’ consists of a comprehensive study of the viability of a mineral project that has advanced to a stage where the mining method, in the case of underground mining, or the pit configuration, in the case of an open pit, has been established, and which, if an effective method of mineral processing has been determined, includes a financial analysis based on reasonable assumptions of technical, engineering, operating economic factors and the evaluation of other relevant factors.*
- *The prefeasibility study, when combined with existing knowledge of the mineral property that is adjacent to mineral deposits that are already being mined or developed, allows management to conclude that it is more likely than not that the Group will obtain future economic benefit from the expenditures*
- *Exploration and evaluation expenditure relating to extensions of mineral deposits which are already being mined or developed, including expenditure on the definition of mineralisation of such mineral deposits, is capitalised as a mine development cost following the completion of an economic evaluation equivalent to a prefeasibility study.*
- *This economic evaluation is distinguished from a pre-feasibility study in that some of the information that would normally be determined in a prefeasibility study is instead obtained from the existing mine or development. This information when combined with existing knowledge of the mineral property already being mined or developed allows management to conclude that more likely than not the Group will obtain future economic benefit from the expenditures.*

Exploration and evaluation assets acquired in a business combination are initially recognised at fair value. Subsequently it is stated at cost less impairment provision. Once commercial reserves are found, exploration and evaluation assets are tested for impairment and transferred to assets under construction. No amortisation is charged during the exploration and evaluation phase.

Extract from annual report and accounts 2011, Impala Platinum Holdings Limited, p. 125-126

33. As per the DP, the following was noted: *“An accounting model for extractive activities that focuses on phases of activities is not recommended. Instead, the approach the project team recommends is to apply the asset definition and recognition criteria in the Framework to determine when, during the extractive activity process, there is an asset that can be recognised in the financial statements. To determine at what point during the extractive activity process there is an asset that should be recognised, it is necessary to consider that activity in the context of the Framework’s definition of an asset that states that an asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.*
34. *Therefore an asset is something that:*
- a) has enforceable rights that enable an entity to access or deny (or limit) the access of others to the economic resource (in other words, the economic resource can be controlled);*
 - b) has positive economic value (in other words, future economic benefits are expected); and*
 - c) currently exists.*

These are the core components of the conceptual definition of an asset. This is apparent from both the Framework’s definition of an asset and the proposed revised definition being considered as part of the IASB/FASB conceptual framework project.

That being said, an asset is recognised when:

- a) it is probable that the future economic benefits will flow to the entity; and*
 - b) the asset has a cost or value that can be measured reliably.*
35. *These are the existing asset recognition criteria (as per paragraph 89 of the Framework). However, the asset recognition criteria are under review as part of the IASB/FASB conceptual framework project. Furthermore, in IFRS 3 Business Combinations and as part of the deliberations on IAS 37 Provisions, Contingent Liabilities and Contingent Assets, the IASB has decided to include probability assessments in the measurement of an asset or liability rather than in determining whether that asset or liability should be recognised. Consequently, both the existing asset recognition criteria and the implications of removing probability from asset recognition are considered in this analysis for completeness.” [DP paragraph 3.7 to 3.11].*
36. This paper also sets out the project team’s view on recognition of assets and states the following:

“The project team’s view is that rights and information associated with minerals or oil and gas properties satisfy the asset recognition criteria. Recognising information as part of the minerals or oil and gas property particularly during the exploration and evaluation phases would lead to a change in existing accounting policies for many minerals entities that recognise all exploration costs as expenses when incurred and for those oil and gas entities that use successful efforts accounting. For example, under successful efforts accounting, unsuccessful drilling and seismic surveying costs incurred during exploration and evaluation are not recognised as assets and are therefore recognised as expenses. Viewing the information gained

from exploration as part of the minerals or oil and gas property results in it being recognised as part of that asset. On a historical cost basis of accounting, those costs would be capitalised as part of the minerals or oil and gas property, unless the legal rights meet the criteria to be derecognised.

This treatment of costs associated with unsuccessful exploration and evaluation activities can be contrasted with the requirements in IAS 2 and IAS 16 for measuring the cost of inventories and self-constructed plant and equipment. Both IFRSs state that abnormal amounts of wasted materials, labour or other resources are not included in the cost of these assets. The focus in IAS 2 and IAS 16 on abnormal amounts of waste presumes a normal amount of waste that can be identified and is capitalised—only abnormal amounts are required to be recognised as expenses. This concept of ‘normal’ and ‘abnormal’ amounts cannot be applied to exploration activities. Also, abnormal amounts of wasted material, labour and other resources have no information content and consequently bring no benefit to the inventory or self-constructed asset. In contrast, unsuccessful exploration can improve the understanding of the geology of the minerals or oil and gas property and therefore can represent an enhancement to the legal right asset.” [DP paragraph 3.33 -35].

37. The DP proposed that any costs incurred during the evaluation and exploration phases could be capitalised to the intangible asset being represented by the licence to mine. Several respondents to the discussion paper disagreed and stated that as the future economic benefits cannot be determined with certainty that these cost did not meet the definition of an asset.
38. This is a result of the following: *“The project team proposed in the DP that legal rights, such as exploration rights or extraction rights, should form the basis of an asset referred to as a ‘minerals or oil and gas property’. The property would be recognised when the legal rights are acquired. Subsequent to the acquisition of those rights, the property would be enhanced by:*
- a) information obtained from subsequent exploration and evaluation activities (eg information that will assist the entity in making assessments on the presence of minerals or oil & gas, the extent and characteristics of the deposit and the economics of their extraction);*
 - b) development works undertaken to gain access the minerals or oil & gas deposit; and*
 - c) any additional rights and approvals that are required before the entity is legally entitled to extract the minerals or oil & gas*

Less than two thirds of the respondents responded on this issue. Of those that responded:

- a) most agreed with the proposal to recognise an asset when the legal right are acquired; and*
- b) a significant majority disagreed with the project team’s view that the subsequent exploration and evaluation activities undertaken would always represent an enhancement of the property (at least at the time that information is obtained).*

Many of those respondents suggested that the project team’s analysis of the treatment of those exploration and evaluation activities was inconsistent with the asset recognition criteria in the Framework because the information obtained may not have any probable future economic benefit. As one respondent explained:”

“...we think it is worth noting that exploration activity generally has a success-rate significantly below 50%. I.e. the probability criterion is clearly not satisfied at the individual asset level. An often used rule of thumb for oil & gas exploration drilling (assuming the activity is not very close to existing known reservoirs), for example, is a success rate of 20%. Using the project team’s suggested recognition model under this assumption (without going into the impairment criteria) and further e.g. assume an average evaluation period of 18 months, the result would be that 80% of the exploration expenditures would be recognized as expenses 18 months later than they occurred. We do not believe this model would give more useful information to the users than e.g. a model under which all exploration expenditures are recognised as expenses when incurred. “

“Respondents urged the Board to further consider asset recognition. Respondents made the following suggestions for alternative approaches for accounting for extractive activities:

- a) to recognise a minerals or oil & gas property asset on the same basis as other assets, such as in accordance with IAS 38 and IAS 16. (Respondents that supported this approach to asset recognition typically also recommend that the scope of a future project should extend beyond extractive activities);
- b) to use the reserve and resource classifications to identify the appropriate point to initially recognise the asset; or
- c) to use existing accounting methods that are commonly used and understood within the industries. Those methods include the successful efforts method and the full cost method, which are historical cost accounting methods that determine whether a cost is capitalized or expensed based on the phase of operation (eg exploration or development) and the activity being undertaken.

In addition, some respondents—particularly some large oil & gas companies that have long-standing accounting policies that are consistent with US GAAP—indicated that the DP does not adequately make the case for changing existing accounting policies that are being consistently applied and that are well understood by users of financial statements.

One respondent had a different perspective on asset recognition for extractive activities. That respondent stated:”

“We think that asset recognition for extractive industries is an “all or nothing” situation, meaning an entity either fully capitalizes expenditures or expenses them, because any attempt at setting up parameters in the middle (e.g. by “stage” of activity) will be arbitrary. The accounting model applicable to extractive activities should recognize this fact.”

39. We do not support the view of these respondents. If an entity installs a security system, no person would question the accounting of these costs if it were to be capitalised. This is because the security systems economic benefit is the limitation of future losses due to theft.

The same argument can be used for the costs incurred in the evaluation and exploration process. These costs incurred limited the future losses of developing a mine on a non-economical site. As such there is future economic benefit for the entity in incurring such costs.

40. It is noted that IAS 38 has the requirements to expense research costs and to only capitalise development expenditure once the following certain criteria has been met:

“An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

- a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.*
- b) its intention to complete the intangible asset and use or sell it.*
- c) its ability to use or sell the intangible asset.*
- d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.*
- e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.*
- f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.”*

[IAS 38 paragraph 57]

41. We thus agree that certain expenditures although they could be argued to meet the definition of an asset would be expensed; at least all entities applying IAS 38 would be on an equal footing. Hence, it is thus our proposal to remove the scope exemption from IAS 16 as well as IAS 38.
42. When a project on intangible assets is put on the active agenda of the IASB the accounting for research and evaluation could be reconsidered at that stage. We are of the view, in light of the possible changes to the definition of an asset, that research costs do represent an asset, as discussed above it provides the entity with information to limited losses in the development of unviable products as an example. However the current criteria in IAS 38 would need to be considered to enable an entity to capitalise such expenditure.

Question 5

This paper proposes that certain expenditures incurred in the exploration and evaluation phases should be accounted for either in IAS 16 or IAS 38? Do you agree with this view, if not, why not?

Asset Measurement

Initial measurement

43. Much debate and time had been applied in the research process of the project team drafting the DP. As per the DP the following was noted:

“The Framework identifies several different measurement bases for assets and liabilities but does not provide guidance on selecting between those measurement bases. At the time this discussion paper was prepared, the joint IASB/FASB conceptual framework project had started to address this topic. However, the boards’ deliberations were at an early stage and did not provide any guidance that the project team could use in addressing measurement.

The measurement bases used in financial reporting can be broadly categorised as either historical cost or current value. Historical cost measures are based on the amount of cash paid or other consideration and may vary depending on the cost elements included. (In addition, historical cost measurements under IFRSs are subject to impairment testing using a current value measurement.) Current value measures include, among others, fair value and value in use.

Historical cost is commonly used by entities in the extractive industries to measure minerals or oil and gas properties. Extensive literature has been developed for the oil and gas industry on two specific variations of historical cost—successful efforts accounting and full cost accounting. A further variant of historical cost—area of interest accounting—is particularly prevalent in the minerals industry.

The initial recognition of minerals or oil and gas properties is made either when the exploration rights have been acquired or when the property is subsequently acquired by the entity through either an asset acquisition or a business combination. The discussion paper identifies issues associated with preparing current value estimates for these assets. A broader issue that may arise concerning the use of fair value at initial recognition is the potential for day 1 gains or losses to be recognised when exploration rights are acquired by staking a claim on an exploration area. As noted, the purchase price of these rights is unlikely to correspond to the asset's fair value. Therefore, in these cases, it would need to be determined whether it is appropriate to recognise a gain or loss on initial recognition of these exploration rights.

An additional issue arises if the current value measurement basis is not fair value. As the consideration given to acquire a minerals or oil and gas property will, in many cases, be equivalent to the asset's fair value, it would need to be determined whether the initial measurement of the asset should be at current value (as defined by the future IFRS) or fair value (as would be required by, for example, IFRS 3 Business Combinations). If the measurement basis is a current value other than fair value, there is likely to be a gain or loss when the property is first measured at that current value.”

The discussion paper goes further to state that: “

The research does not provide substantive support for either historical cost or fair value as the measurement basis for exploration properties and minerals or oil and gas properties. Historical cost generally does not provide relevant information. Fair value conceptually provides relevant information. However, owing to the subjectivity and degree of estimation involved, users do not view entity-prepared current values as being representationally faithful, and therefore they would make limited use of them. In the project team's view, information that is not used is not relevant. Preparing current value estimates of these assets involves significant work effort and cost. The project team thinks that measuring these assets at current value would not meet a cost-benefit test. For the reasons discussed above, the project team also does not support measuring the assets in the financial statements at a current value similar to a standardised measure.

This might suggest that all exploration, evaluation and development expenditures should be recognised as expenses. However, this would seriously misstate the statement of comprehensive income because expenditures that result in future value to the entity would negatively affect income. It would also result in not recognising assets of the entity.

An entity that found and developed a minerals or oil and gas property would show negative income until production began. This cannot be considered faithfully representational. The use of

historical cost as the measurement basis would address these issues. The statement of comprehensive income would not be negatively affected by expenditures that create or increase the value of assets. Assets would be recognised in the statement of financial position, although this would be at amounts that are not relevant to most users. Historical cost is also a less costly measurement basis for preparers, although existing historical cost practices have developed over many years and are sometimes more complex than they need to be.

If historical cost remains the measurement basis for exploration properties and minerals or oil and gas properties, the project team believes a single approach should be developed and that, given the limited relevance of historical cost, one of the principles of that approach should be simplicity. In other words, a historical cost accounting model for these assets should not be complicated by detailed and prescriptive cost allocation and requirements to capitalise or recognise as expense.

However, the project team acknowledges that the historical cost measurement of these assets would need to be subject to depreciation calculations and impairment testing.

44. The conclusions reached and confirmed by respondents to the discussion paper was that initial measurement of the asset associated with extractive activities should be cost. The FRSC would like to get views of EEG members on this approach and a proposal to remove the scope exemptions currently found in IAS 16 and IAS 38.

Question 6

Do you support the view that assets associated with extractive activities should be initially measured at cost? If not, which measurement basis should be applied to these assets?

Subsequent measurement

45. Both IAS 16 and IAS 38 have options for measuring the asset at its Fair Value. The discussion paper noted the following:

“Most other non-financial assets are measured at historical cost under IFRSs. IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets both require assets to be measured at cost on initial recognition and permit either the cost model or the revaluation model to be used for subsequent measurement. In practice, the revaluation model is rarely used when applying those IFRSs. However, there are some other types of non-financial assets for which fair value measurement is more common. IAS 40 Investment Property permits investment properties to be measured using either a cost model or a fair value model, although common practice is to measure these assets at fair value. IAS 41 Agriculture goes further, by requiring biological assets related to agricultural activity to be measured at fair value less costs to sell, unless they cannot be reliably measured at fair value on initial recognition.

Examining existing practices may provide useful insights in developing a new IFRS. It may be particularly useful to understand the accounting policy choices made by preparers under existing standards. However, existing practices may have developed for many reasons and they do not necessarily represent accounting practices that best meet the objective of financial reporting. For this reason, the project team’s proposals are developed on the basis of the Framework, focusing on meeting the objective of financial reporting.

IAS 16, IAS 38 and IAS 40 provide a choice of measurement models to apply. The Preface to International Financial Reporting Standards explains that the IASB does not intend to permit

choice in accounting treatments, and so this choice is not being proposed for minerals or oil and gas properties.”

46. Fair value is one of the main forms of current value and one that is most commonly used in IFRSs. The discussion paper states that:

“The current value of an asset is based on the future cash flows that the asset is expected to generate, either from selling the asset or from using the asset in producing goods or providing services. Because users of financial reports are interested in assessing the entity’s ability to generate net cash inflows, current value measurements such as fair value are often viewed as being conceptually consistent with the financial reporting objective of providing financial information that is useful in making decisions about providing resources to the entity and in determining whether the directors and management have made efficient and profitable use of the resources provided

The conceptual benefits of current value measurements were confirmed by the users consulted throughout the research project. Equity analysts are interested in estimating the value of the entity, and the value of the 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. Lenders and creditors are interested in whether the future cash flows that are expected to be generated from these assets will be sufficient for the entity to meet its obligations.

However, both users and preparers identified significant concerns about whether current value estimates of minerals or oil and gas properties would possess the qualitative characteristic of faithful representation— and therefore whether, in practice, a current value would provide information that could be relied on by users. Information that cannot be relied on is not useful. These concerns focus on the methodology required to derive a current value for minerals or oil and gas properties and the number of assumptions required.”

47. It has been noted in the discussion paper that:

“Current value measurements other than fair value would also be estimated using the income approach. In the project team’s view, a current value measurement other than fair value can be considered a substitute for fair value only if it provides some useful information about future cash flows and if it addresses some of the concerns about the preparation time and effort and subjectivity associated with estimating the fair value of minerals or oil and gas properties.

The concerns associated with developing a fair value measurement can be reduced by:

- (a) assigning a value to only a portion of the asset (eg proved reserves but not probable reserves or resources); or*
- (b) specifying either the values to be used for certain inputs or the method by which those inputs are to be derived.*

A current value measurement prepared on this basis would not represent fair value. An example of such a current value measurement is the standardised measure of discounted future net cash flows relating to proved oil and gas reserve quantities that is required to be disclosed by FASB ASC paragraph 932-235-50-30. The scope of this standardised measure is limited to the future cash flows expected from the entity’s proved reserves rather than future cash flows attributable to the entire property—which may also include probable and possible

reserves, contingent resources and future exploration potential. Also specified, among other things, is the use of a 10 per cent discount rate, a price assumption equal to the average price of the commodity for the previous year and year-end costs. The standardised measure goes some way toward reducing the effort and limiting the need for disclosure of proprietary data and, by reducing subjectivity, it also increases consistency of the measurement between entities. However, there is a trade-off—the more the inputs are specified the less likely it is that the valuation will be relevant to a user’s understanding of the net future cash inflows attributable to the entity’s assets.

In practice, there is a general acceptance among users and preparers that the standardised measure does not provide a faithful representation of the year-end value of the entity’s oil and gas properties, or even a faithful representation of the value attributable to its proved reserves. Many preparers explicitly include a statement to this effect as part of their standardised measure disclosures. One of the reasons for this is that a historical price (such as the 31 December spot price or a twelve-month average price) may be significantly different from the long-range price outlook because of short-term supply or demand factors. Nevertheless, a standardised measure may be useful for purposes other than as a valuation of the future cash flows expected from proved reserves. Some users surveyed by the project team noted that they use the standardised measure disclosure to provide a preliminary comparison of the reserve quantities and standardised measure of different entities and to understand changes to the entity’s standardised measure from one year to the next.

In the project team’s view, the standardised measure required by FASB ASC paragraph 932-235-50-30, or a similar current value measurement that either assigns a value to only a portion of the asset or standardises some of the valuation inputs, will not provide useful information about future cash flows. Therefore, for the purposes of presenting an entity’s statement of financial position, these forms of current value measurement are not suitable alternatives to measuring minerals or oil and gas properties at fair value.

Another form of current value measurement, such as a value in use estimate, could be suitable as a substitute to fair value measurement. The value in use measurement would, at least conceptually, provide useful information because it would show the future cash flows that the entity expected to generate from its assets. However, the current value measurement would not address the concerns of users (see paragraph 4.23).

It would also not use market-based inputs (where available) and therefore might be less useful to users than fair value. Furthermore, a value in use measurement would not address any of the concerns raised by preparers about the preparation cost and effort required and the concern that commercially sensitive information might be disclosed. For these reasons, the project team’s view is that fair value is the most suitable current value measurement basis that could be applied to minerals or oil and gas properties.

The main issues associated with the current value measurement of minerals or oil and gas properties after initial recognition are the frequency of the remeasurement which is discussed in the following paragraphs) and the implications of the remeasurement on the statement of comprehensive income.

In remeasuring other types of non-financial assets at fair value, IFRSs require the remeasurement to be performed either:

- (a) each reporting period, including interim periods—which is the approach adopted by IAS 40 and IAS 41; or*

- (b) *on a periodic basis, but with sufficient regularity to ensure that, at the end of the reporting period, the asset's carrying amount does not differ materially from its fair value—which is the approach adopted by IAS 16 and IAS 38.*

In the project team's view, this distinction between the frequencies of these remeasurements is unlikely to be relevant in practice for minerals or oil and gas properties. This is because the fair value of these assets is continually changing as more information is obtained about the property, as economic conditions change, and as the minerals or oil and gas are extracted. Therefore, if the property is not remeasured at fair value at the end of each reporting period, it is likely that its carrying amount would materially differ from its fair value. Unless fair values were determined at each reporting date, the measurement of those assets would not faithfully represent the entity's financial position or the entity's financial performance for the reporting period. For this reason, the project team thinks that if minerals or oil and gas properties are to be measured at fair value, those assets would have to be remeasured at fair value each reporting period, including interim periods. As noted, this would have substantial preparation cost implications for minerals and oil and gas entities.

48. The DP discusses the three main approaches in estimating fair value, namely the market approach, cost approach and the income approach. Under the discussion paper it has been noted that users and preparers have the following views on fair value measurement:

Users consulted throughout the project expressed concern that some or all of the inputs used by an entity in deriving the fair value of minerals or an oil and gas property might be different from those that the user would wish to apply. These users noted that the independent assessment of the various uncertainties is a critical part of their role and that relying on management's assessment of these factors is inconsistent with this.

For these reasons, users indicated that they would not directly use management's estimate of fair value in their own analysis. Some users noted that a fair value included in the financial statements might be useful as a cross-check with their own value estimates. This would require disclosure of the main assumptions such as future commodity prices and capital costs in order to understand the reasons for the differences between the user's valuation and the fair value measurement included in the financial statements

Preparers consulted by the project team shared the users' concerns about the difficulty in estimating a current value and about the subjectivity involved. They also raised concerns about the effort involved in generating fair values, particularly for those entities with multiple properties that might produce different commodities and be in different jurisdictions with different political and other risks. Preparers thought that this would impose significant preparation costs—either opportunity costs for entities that have to redirect technical expertise from operational activities to compliance or incremental costs to engage outside consultants. Preparers and auditors also expressed concerns about the additional time and cost to prepare and audit this information and the impact on their ability to complete the financial reporting process to meet the deadlines for regulatory reporting requirements.

Preparers told the project team that the current standardised measure of oil and gas reserves required by FASB ASC paragraph 932-235-50-30— which is limited to future cash flows attributable to proved reserves— takes four weeks or longer to prepare (depending on the specifics of the entity's properties). A full fair value of a minerals or oil and gas property would take much longer. Some entities also claimed that disclosing inputs to a fair value

might require them to disclose proprietary information (such as their future pricing outlook or their contracted prices), which could be detrimental to their competitive position.

Fair value measurement is used in measuring impairment for minerals or oil and gas properties and for determining the initial measurement of the properties acquired in a business combination. This raises the question of why fair value can be used for these purposes but not for the ongoing measurement of those properties. Several reasons are often put forward to explain this. An impairment or business combination will usually affect substantially less than all of an entity's minerals or oil and gas properties. The calculations can often be done well in advance of the end of the reporting period (and, in the case of a business combination, finalised in the following period). Impairments and business combinations do not normally occur every reporting period. In a business combination the value of the properties to be acquired has normally been determined by the acquirer as part of the acquisition process. While this may include entity-specific assumptions that do not reflect the views of market participants, it would still be useful in determining the fair value of the acquired properties. These factors mitigate, but do not eliminate, the practicality and subjectivity concerns about the use of fair values in impairment testing and business combinations

Preparers generally concluded that fair value measurement would be costly to implement while producing little, if any, benefit for users. Preparers noted that users do not request fair value information and rarely display interest in fair value or other current value information about these assets that is sometimes made available in financial statements or in regulatory filings (e.g. business combinations disclosures, disclosure of a standardised measure of proved oil and gas reserves). Accordingly, preparers do not think that measuring minerals or oil and gas properties at fair value would meet a cost-benefit test."

49. However if the scope exemption is simply removed from IAS 38, as proposed, IAS 38 indicates that an active market for the intangible asset to be measured at fair value needs to exist. We are of the view that this option would rarely if ever be chosen by entities.

Question 7

The paper suggests the removal of the scope exemption in IAS 38 to allow entities engaged in extractive activities to subsequently measure its intangible assets at cost or revaluation? Do you agree with the removal of this scope exemption?

Depreciation

50. It is noted that consistent with the views expressed in the discussion paper that IAS 16 and IAS 38 should provide an appropriate basis to determine the depreciation/amortisation rate.
51. One of the issues identified in the discussion paper had been address with recent amendments to IAS 16 and IAS 38, which indicated that depreciation/amortisation rates based on revenue would not be appropriate or at a minimum highly unlikely.
52. We acknowledges that considering reserves or probable reserves or even including some resource classifications in determining the units of production does represent some challenges. However where consistent definitions are applied guidance could easily be developed.

53. What should be noted is that depreciation is a method to recognise the cost incurred in creating an asset over the period/units that would bring economic benefit to the entity.
54. This economic benefit would constantly be reassessed and would thus affect the depreciation being recognised going forward as such as long as it is being consistently applied and continuously reassessed it would meet the objective.
55. Below are *examples of accounting policies for depreciation*.

Xstrata Plc

On initial acquisition, land and buildings and plant and equipment are valued at cost, being the purchase price and the directly attributable costs of acquisition or construction required to bring the asset to the location and condition necessary for the asset to be capable of operating in the manner intended by management. In subsequent periods, buildings, plant and equipment are stated at cost less accumulated depreciation and any impairment in value, whilst land is stated at cost less any impairment in value and is not depreciated. Depreciation is provided so as to write off the costs, less estimated residual values of buildings and plant and equipment (based on prices prevailing at the balance sheet date), on the following bases:

Mine production assets are depreciated using a unit-of production method based on estimated economically recoverable reserves, which results in a depreciation charge proportional to the depletion of reserves.

Extract from annual report and accounts 2011, Xstrata Plc, p. 127-128

ENRC Plc

Once a project has been fully commissioned, depreciation is charged using the units of production method, based on proved and probable reserves, with separate calculations being made for each area of interest. The units of production basis results in a depreciation charge proportional to the depletion of proved and probable reserves.

Extract from annual report and accounts 2011, ENRC Plc, p. 82-83

Impairment

56. The discussion paper made some suggestions to treat exploration assets differently from other assets when determining whether there is a need to recognise impairment. The alternatives to applying the IAS 36 impairment model to exploration properties include:

Option A—revisiting the project team’s view on initial recognition 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;

Option B—allowing entities to recognise an impairment loss for an exploration property without having to calculate recoverable amount in cases where preparing that calculation would involve undue cost or effort; or

Option C—identifying indications of impairment that are different from those in IAS 36 and apply specifically to exploration properties.

57. Under Option A, the following have been noted in the discussion paper:

“The project team’s view on initial recognition, is that the information obtained from both successful and unsuccessful exploration and evaluation activities improves the understanding of the geology of the exploration property. Consequently, the costs of these activities should be capitalised because they are an enhancement to the asset even though sufficient information may not yet be available to indicate the existence of economically recoverable quantities of minerals or oil and gas. An alternative to the project team’s view on initial recognition would be to recognise the asset only when sufficient information is available to indicate the existence of economically recoverable quantities of minerals or oil and gas. This alternative would result in most exploration and evaluation costs being recognised as expenses as incurred unless those costs are otherwise capable of being recognised as assets in accordance with IAS 16 or IAS 38.*

This option would be somewhat similar to successful efforts accounting in the oil and gas industry but it would require some costs that are generally capitalised under existing practice to be recognised as expenses. For example, the cost of drilling a successful oil exploration well may need to be recognised as an expense as incurred if the cost is incurred before sufficient information is available to assess whether the reservoir that has been discovered contains economically recoverable quantities of oil or gas. Exploration properties would be recognised in the financial statements—but would be measured at the cost of acquiring the rights. This option also requires an entity to determine when there is sufficient knowledge about the property for an estimate of future cash flows to be made.

In the project team’s view, this option is inconsistent with the application of the asset definition and recognition criteria because it would lead to the recognition as expenses of costs that improve knowledge about an exploration property and therefore misstate the financial performance of an entity as reflected in the statement of comprehensive income.”

58. Under Option B, the following have been noted in the discussion paper:

“Under this option, IAS 36 would apply to exploration properties, but entities would be provided with an ‘undue cost or effort’ exemption from calculating recoverable amount for an exploration property if the benefits of calculating recoverable amount did not justify the costs involved. Entities taking this option would write down the property’s carrying amount to zero. The exemption would be taken property by property because there may be some properties for which a comparison can be made between its recoverable amount and its carrying amount with reasonable effort. In subsequent reporting periods, if there were sufficient information to indicate the existence of economically recoverable quantities of minerals or oil and gas, IAS 36 would require a reversal of the impairment.

This option has the advantage of ensuring that the entity’s statement of financial position is not overstated during the early stages of exploration and that the cost of the minerals or oil and gas property is not understated when the property is likely to proceed to development, because by then the impairment would be expected to have reversed.

A disadvantage of providing an ‘undue cost or effort’ exemption is that it could be used to facilitate the ‘smoothing’ of an entity’s financial performance between reporting periods. Furthermore, the use of ‘undue cost or effort’ exemptions has previously been proposed—but not subsequently adopted—in amendments to IFRS 3 Business Combinations (about

measuring non-controlling interests at fair value), IAS 1 Presentation of Financial Statements (about reclassification of comparative amounts and disclosure of key assumptions and other sources of estimation uncertainty) and IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors (about retrospective application of voluntary changes in accounting policies and retrospective restatement for fundamental errors). In each of those cases, the IASB decided not to use an 'undue cost or effort' exemption because an exemption based on management's assessment of undue cost or effort was too subjective to be applied consistently by different entities. The project team agrees that the same concern would arise with the approach adopted for testing exploration properties for impairment."

59. Under Option C, the following have been noted in the discussion paper:

This option involves identifying indications of impairment that apply specifically to exploration properties since, as noted, the indications in IAS 36 cannot be applied effectively to determine whether an exploration property should be tested for impairment.

An indication of impairment would have to be able to predict whether the carrying amount of a specific exploration property is likely to be greater than its recoverable amount without requiring the asset's recoverable amount to be calculated.

The types of impairment indicators identified in existing standards as being appropriate for exploration properties mainly address whether there is an asset that can continue to be recognised rather than whether the carrying amount of that asset is recoverable. IFRS 6 paragraph 18 requires exploration and evaluation assets to be tested for impairment 'when facts and circumstances suggest that the carrying amount exceeds the recoverable amount'. The facts and circumstances listed in paragraph 20 of IFRS 6 are:

- (a) the period for which the entity has the right to explore in the specific area has expired during the period or will expire in the near future, and is not expected to be renewed.*
- (b) substantive expenditure on further exploration for and evaluation of mineral resources in the specific area is neither budgeted for nor planned.*
- (c) exploration for and evaluation of mineral resources in the specific area have not led to the discovery of commercially viable quantities of mineral resources and the entity has decided to discontinue such activities in the specific area.*
- (d) sufficient data exist to indicate that, although a development in the specific area is likely to proceed, the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full from successful development or by sale.*

The first three of these four criteria address derecognition of the asset. The fourth criterion addresses recoverability but, as previously discussed, sufficient data will not normally exist to determine that 'the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full'.

The project team has not been able to identify any indications of impairment that would be useful in predicting whether and when the carrying amount of an exploration property is not recoverable. This is because if information about the presence of minerals or oil and gas on an exploration property is too limited to use for predicting future cash flows (or otherwise determining the recoverable amount), the information is likely to be equally insufficient for any objective indicators to make accurate predictions about the recoverability of a property. To make such predictions, the indicators would have to distinguish between situations where:

- (a) *the information, while limited, is sufficiently positive and the carrying amount of the property sufficiently low for the likelihood of the carrying amount being recoverable to be very high;*
- (b) *even though exploration will continue, the exploration results to date make it very unlikely that the carrying amount will be recovered in full; and*
- (c) *most commonly, there is insufficient information to judge recoverability with any reasonable degree of confidence.*

For this reason, testing exploration properties for impairment may need to be based largely on management's expectations of the recoverability of its properties rather than on the existence of any objective indicators that those properties are impaired. Because different managements may manage their exploration and evaluation activities differently and have different perceptions of how well those activities are progressing, the project team thinks that it would also be difficult to prescribe how management should assess the recoverability of its properties. Consequently, this option identifies the following principle for testing these assets for impairment—management should be required to write down an exploration property only when, in its judgement, there is a high likelihood that the carrying amount of the property would not be recovered in full.

Compared with IAS 36, this principle is intended to defer when exploration properties are tested for impairment. This is because, until an exploration programme is sufficiently advanced, it is unlikely that management would have enough information to assess whether it is highly likely that the carrying amount of the property is not recoverable. The project team thinks that how an exploration programme is managed should provide insight as to whether management has sufficient information to make such an assessment. For instance, more information would need to be obtained and analysed before an assessment can be made about the recoverability of a property if exploration has only recently begun on the property or if exploration results to date support continuing with the exploration programme.

In contrast, if management is considering significant reductions to its exploration programme, such as planning to abandon the property or wind down its exploration and evaluation activities on that property (e.g. by reallocating equipment and personnel to other exploration programmes), then this may indicate the need for an impairment test.

In addition, given the absence of objective indicators to predict whether exploration properties are impaired, this option would include a separate set of indicators to assess whether an asset can continue to be recognised. This is consistent with the approach adopted in IFRS 6 and US GAAP. These indicators would be based on the existence of evidence that the asset can continue to be recognised (i.e. positive indicators) rather than on the absence of evidence that would indicate that the asset is impaired or should be derecognised (i.e. negative indicators). Consequently, the indications may be based on facts and circumstances where:

- (a) *minerals or oil and gas has been discovered on the property, but further exploration and evaluation is required to assess the size and quality of the deposit and to determine whether the minerals or oil and gas can be extracted economically; and*
- (b) *minerals or oil and gas have not yet been discovered, but substantive exploration and evaluation activities in a specific location within the exploration property are continuing. This indication links to the project team's view on the unit of account of an exploration property, because an exploration property (or part thereof if there is more than one unit of account for that property) will be derecognised when exploration and*

evaluation activities cease or are abandoned on the property (or that part of the property)."

60. The sub-committee is not supportive of these approaches as it would lend itself to easy manipulation by management to achieve for example smoothing of earnings. Therefore the discussion paper sets out the following in terms of impairment of exploration assets:

"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. However, for most exploration properties, this information is not likely to be available while exploration and evaluation activities are continuing, and particularly when those activities are not yet at an advanced stage. Accordingly, the project team also recommends that exploration properties should be tested for impairment on a basis that is consistent with Option C. Therefore, management would be required:

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

Different managements may take different views on whether an exploration property should be written down—and by how much. This is unavoidable given the very limited information that exists for the typical exploration property. For this reason, the project team thinks that an entity's financial report should also include:

- (a) separate presentation of exploration properties in the financial statements*
- (b) for exploration properties written down in the period, disclosure of the factors that led management to determine that the exploration properties were impaired and the remaining carrying amount of exploration properties that have been impaired; and*
- (c) for exploration properties not written down in the period, disclosure of management's views on why those properties continue to be capitalised in the financial statements.*

Paragraph BC224 of the Basis for Conclusions on IAS 36 states that the 'IASB acknowledged that an enterprise would use judgement in determining whether an impairment loss needed to be recognised. For this reason, IAS 36 included some safeguards to limit the risk that an enterprise may make an over-optimistic (pessimistic) estimate of recoverable amount'. The project team thinks that the disclosures about exploration properties, should provide an appropriate safeguard against an entity making any unduly optimistic or pessimistic estimates of a property's recoverable amount.

The project team thinks that an impairment assessment should be carried out separately for each exploration property. Consistently with IAS 36, the carrying amount of an exploration property that is impaired should be written down to its recoverable amount. In some cases, this recoverable amount assessment could be performed at a cash-generating unit level rather than at an individual property level. However, the project team is not proposing to continue the accounting policy choice permitted by IFRS 6 to allocate exploration properties to groups of cash-generating units for the purpose of assessing impairment."

61. There is an option that these assets can be treated in line with the requirements of IAS 16 and IAS 38.

62. It would thus only be possible to recognise the costs incurred once the entity has been able to demonstrate the IAS 38.57 recognition criteria for development costs. In demonstrating those criteria, we are considering the option that the entity should have sufficient information to enable it to carry out an impairment test should the indicators of impairment be present.
63. Below is an example of an accounting policy on impairment.

Impala Platinum Holdings Limited

For the purposes of assessing impairment, the exploration and evaluation assets subject to testing are grouped with existing cash-generating units of operating mines that are located in the same geographical region. Where the assets are not associated with a specific cash generating unit, the recoverable amount is assessed using fair value less cost to sell for the specific exploration area.

Extract from annual report and accounts 2011, Impala Platinum Holdings Limited, p. 125-126

64. It would thus be our proposal that the impairment guidance/requirements in IFRS 6 no longer be used and that IAS 36 be applied.

Question 8

This paper proposes that the impairment guidance in IAS 36 is appropriate to apply to exploration and evaluation assets? Do you agree with this view?

Disclosure

65. There were a large amount of negative comments received on the disclosure proposals contained in the Discussion Paper. The said disclosure proposals were as follows:

	Disclosure type	Information to disclose	Level of detail
1	Reserve quantities	<ul style="list-style-type: none"> • Proved reserves and proved and probable reserves • Estimation method • Main assumptions • Sensitivity analysis to main assumptions • Reconciliation of changes in reserve quantities 	<ul style="list-style-type: none"> • By commodity, and further broken down by country or project (where material)
2A	Current value measurement (if asset is measured at historical cost)	<ul style="list-style-type: none"> • Option A: Range of estimates of fair value • Option B: Standardised measure of proved and probable reserves • Preparation basis • Main assumptions • Reconciliation of changes in current value 	<ul style="list-style-type: none"> • Generally disclosure by major geographical region

	Disclosure type	Information to disclose	Level of detail
2B	Fair value measurement (if asset is measured at fair value)	<ul style="list-style-type: none"> • Fair value estimate • Main assumptions • Sensitivity analysis to main assumptions • Reconciliation of changes in reserve values • Other disclosures similar to the proposals in the exposure draft <i>Fair Value Measurement</i> 	<ul style="list-style-type: none"> • Generally disclosure by major geographical region <p>Should include the fair value of what the entity has access to</p>
3	Production revenues	<ul style="list-style-type: none"> • Production revenues 	<ul style="list-style-type: none"> • By commodity
4	Costs	<ul style="list-style-type: none"> • Exploration costs • Development costs • Production costs 	<ul style="list-style-type: none"> • Disaggregated as per reserve quantities • Time series of disclosure over five years

66. A lot of these negative comments noted that regulators around the world already have extensive disclosure requirements and that these in certain instances duplicate those and in other instances could be significantly different.
67. Disclosures required by various regulators arose due to the lack of disclosure requirements in IFRS. Should consistent and comprehensive disclosure be contained in the requirements of IFRS such regulators would more easily relax their requirements, as their requirements had arisen due to the need to provide their stakeholders with the information.
68. We note the proposal in the discussion paper on using definitions that are firstly comparable across the industries and secondly widely used in practice as one option in addressing consistency.
69. Should a consistent and comparable method be used in arriving at the required disclosures, the concerns raised surrounding the location of the disclosures and regards to the audit requirements might be greatly reduced.
70. A further matter to consider that is jurisdictions where the regulators are not yet as developed that very little if any disclosures are required from entities operating in those jurisdictions.

Question 9

Do you agree with the proposal that a separate disclosure standard for extractive activities should be developed?

Other Matters

Unit of Account

71. This matter remains a concern and a cause to much of the perceived inconsistencies in the application of IFRS in general.
72. Specifically for entities engaged in extractive activities, the unit of account would be crucial in the following points as examples:
 - determining when a project has become a development and no longer research as defined in IAS 38, under the sub-committees proposals contained above.
 - Whether the conditions for capitalising expenditure for development has been met.
 - Determining the appropriate units of production to calculate depreciation/amortisation rates.
 - Impairment testing.
 - Decommissioning and Rehabilitation.
 - Application of IFRIC 20 is also being viewed as inconsistent due to differing views on the unit of account.

Examples of accounting policies relating to CGU as well as operating segments:

ENRC Plc

The carrying amounts of property, plant and equipment and all other non-financial assets are reviewed for impairment if facts and circumstances indicate that impairment may exist. Goodwill is tested for impairment annually in accordance with paragraph 99 of IAS 36 or

Cash Generating Units ('CGU') where there has been significant headroom in the preceding assessment. In other CGUs, the recoverable amount is assessed by reference to the higher of 'value in use' (being the net present value of expected future cash flows of the relevant cash generating unit) and 'fair value less costs to sell' (the amount obtainable from the sale of an asset or CGU in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal). Where there is no binding sale agreement or active market, fair value less costs to sell is based on the best information available to reflect the amount the Group could receive for the CGU in an arm's length transaction and based on Net Present Value ('NPV') of expected future cash flow of relevant CGUs. A CGU is 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.

The estimates used for impairment reviews to determine 'value in use' are based on detailed mine plans and operating budgets, modified as appropriate to meet the requirements of IAS 36 'Impairment of Assets'. Future cash flows are based on:

- *Estimates of the quantities of the reserves and mineral resources for which there is a high degree of confidence of economic extraction;*

- *Future production levels;*
- *Future commodity prices; and*
- *Future cash costs of production, capital expenditure related to construction in progress and development projects that are not yet completed, close down, restoration and environmental clean-up, if the carrying amount of the asset exceeds its recoverable amount, the asset is impaired and an impairment loss is charged to the income statement so as to reduce the carrying amount in the balance sheet to its recoverable amount. A previously recognised impairment loss is reversed if the recoverable amount increases as a result of a reversal of the conditions that originally resulted in the impairment. This reversal is recognised in the income statement and is limited to the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognised in prior years. An impairment loss recognised for goodwill is not reversed in a subsequent period.*

Extract from annual report and accounts 2011, ENRC Plc, p. 83

ENRC Plc

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The chief operating decision maker, who is responsible for making strategic decisions, allocating resources and assessing performance of the operating segments, has been identified as the Group Chief Executive Officer.

Extract from annual report and accounts 2011, ENRC Plc, p. 87

73. It has been noted in the discussion paper that:

“There are two dimensions to consider in selecting a unit of account for minerals or oil and gas properties:

- (a) the geographical boundaries of the asset—possible boundaries include individual mine or field, individual geological area (e.g. a sedimentary basin) or individual country or continent; and*
- (b) the components of the unit of account that are to be recognised as a single asset—possible components include the legal rights and information asset (the property asset) or the property plus any associated plant and equipment assets.*

The classification of reserves and resources (e.g. proved reserves, probable reserves) to be accounted for is not considered to be a unit of account issue. This is because the reserve and resource disclosure classifications do not represent different ‘items’—they are different estimates of the same item, being the recoverable minerals or oil and gas associated with the property.”

Further to that it should be noted that: *“There is a range of possible geographical boundaries that could be applied to define the unit of account for minerals or oil and gas properties.*

The possible boundaries could be set by reference to one or more of the following attributes:

- (a) geopolitical characteristics, such as each country or group of countries in which the entity operates (full cost accounting is an example of this).*
- (b) geological characteristics, such as: (i) if a wider unit of account is preferred, a basin or a geological province; or (ii) if a narrower unit of account is preferred, an area of interest.*

- (c) *legal characteristics, e.g. a single area, or group of contiguous areas, for which the relevant rights are held through property rights such as a lease or contract.*
- (d) *economic characteristics, e.g. an area that is managed separately or has independent cash flows.”*

The discussion paper goes further to state that under the asset components approach: *“Identifying the components of a unit of account involves considering, from a functional perspective, which assets are integral to and inseparable from other assets within that unit of account.”*

74. During exploration, the exploration right will represent the unit of account initially. Other assets used during exploration (eg vehicles, drilling rigs, site offices) are not expected to be integral to the exploration rights. Consequently, those assets would be recognised as separate units of account from the exploration property. However during the development phase the assets that are potential candidates for collectively forming a single unit of account are those assets that are used in upstream minerals or oil and gas operations to produce the minerals or oil and gas. Those assets fall into two main groupings:
- (a) legal rights to extract the minerals or oil and gas; and
 - (b) plant and equipment assets.

As noted in the discussion paper the projects team’s view on unit of account is that:

“For exploration rights, the unit of account would initially be defined according to the exploration rights held. As exploration and evaluation takes place, the size of the unit of account would contract so that by the time of development and production the geographical dimension of the unit of account would ultimately be no greater than a single area, or group of contiguous areas, for which the rights are held, which is managed separately, and which would generate largely independent cash flows.

The components approach in IAS 16 may be useful in considering which assets should be recognised separately from the legal rights to extract minerals or oil and gas. The blanket inclusion of all plant and equipment assets associated with a legal right to extract minerals or oil and gas is inconsistent with the abovementioned principles and constraints.

The question is which plant and equipment assets should be included in the same unit of account as the legal rights—and which should not. The project team notes that the extent to which plant and equipment assets are interrelated to the legal rights will depend on the specific facts and circumstances. It would therefore be difficult, and undesirable, for an IFRS to prejudge which assets can and cannot form part of the same unit of account as the legal rights. Professional judgement will need to be exercised if an entity’s minerals or oil and gas properties are to be faithfully represented in the entity’s financial statements. Nevertheless, an IFRS for extractive activities could set some boundaries within which professional judgement is exercised.

The discussion paper identified certain principles for determining the unit of account for minerals or oil and gas properties. Consistently with those principles, determining the items of plant and equipment that should be included in the same unit of account as the legal rights to a geographical area should be based on the following:

- (a) *Plant and equipment assets that generate largely independent cash flows represent separate units of account—in other words, the unit of account that includes the legal rights can be no greater than a cash-generating unit, as determined in accordance with IAS 36.*

- (b) *Plant and equipment assets that are physically and commercially separable should be accounted for as separate units of account— these are assets that could realistically be moved to other operations and the movement of these assets could be economically justified. In contrast, assets are regarded as commercially inseparable if it would be more economic to abandon or decommission them rather than physically move them to a new location. Examples of the latter might include assets that are dedicated to the property because: (i) they are not readily movable (e.g. offices, concentrator, dedicated rail facilities); or (ii) they are specialised so there is no other economic use for them.*
- (c) *Plant and equipment assets that have different useful lives from the legal rights (including any renewal periods that are expected to be obtained) should be accounted for as separate units of account if the minerals or oil and gas properties are to be measured at historical cost.*

In the project team’s view, these factors would set an upper limit to the unit of account. Entities may decide to account for their assets using a smaller unit of account.”

75. We note that it does form part of the IASB’s project on the *Conceptual Framework for Financial Reporting*. The sub-committee thus proposes that the project team dealing with this should consider entities engaged in the extractive activities as part of their scope.

IFRS 3 Application

76. An area of some frustrations that is being experienced where a decommissioning liability needs to be fair valued due to it being part of a business being acquired on the date of the acquisition and then the tension with IAS 37 that requires that liability to be subsequently carried at a best estimate of the amount required to settle the liability. This issue is again not unique to extractive activities but is very common.
77. We recommend that this issue be raised with the IFRS Interpretations Committee to address, should the IFRS 3 post implementation review not indicate that this issue is being addressed.

Business Cycle

78. Due to the very long business cycle of an entity engaged in extractive activities, we are of the view that IAS 36 should be enhanced to include guidance/examples of impairment tests that need to be carried out for several years, i.e. life of mine.

Question 10

Do you agree with the items listed above are issues to be considered by the IASB and the IFRIC and what other issues in extractive activities not dealt with in this paper should be considered?