The South African Institute of Chartered Accountants

CL 20

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Mr. Colin Fleming
Project Manager
International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
United Kingdom

Email: commentletters@iasb.org.uk
Fax: +44 (020) 7246 6411

Dear Colin

EXPOSURE DRAFT 6 – *EXPLORATION FOR AND EVALUATION OF MINERAL RESOURCES*

In response to your request for comments on the exposure draft on *Exploration for and Evaluation of Mineral Resources*, attached please find the comment letter prepared by the South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not just a professional body, but also secretariat for the Accounting Practices Board (APB), which is the official accounting standard-setting body in South Africa.

In addition to our official SAICA comment letter which also represents the view of the standard setter, we have included one further submission, which is the comment letter of the Extractive Industry Project Group of SAICA.

SAICA is a professional body representing Chartered Accountants in South Africa. As part of our structures we have industry project groups, consisting of regulators, accountants and auditors in a particular industry. We are aware that the IASB values the submissions made by the industry.

We would like to thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director - Accounting

cc: Doug Brooking (Chairman of the Accounting Practices Board)
Geoff Everingham (Chairman of the Accounting Practices Committee)

SAICA COMMENT LETTER ON ED 6

GENERAL COMMENTS

SAICA supports ED 6 as interim guidance until such time as a comprehensive project is completed. We would, however, encourage the International Accounting Standards Board (IASB) to give priority to a comprehensive project on extractive industries so as to reduce the period for which this interim guidance is applicable.

We would like to highlight the following main areas of concern with the proposed standard:

- ED 6 does not improve the comparability of reporting by entities under International Financial Reporting Standards (IFRS), as the guidance provided is very limited. As a result, the objective of the proposed standard to enhance comparability between entities (as portrayed in IN2) is not met. The ability of entities to apply a number of accounting policies will not result in consistent financial reporting practices (see further comments under Question 1).

- Conceptually, we have a concern with the proposed exemption from the hierarchy, but understand that the IASB has adopted a pragmatic approach for now (see further comments under Question 2).

- We are concerned that the impairment test (even for a cash-generating unit for exploration and evaluation assets) may result in companies having to impair assets previously not required to be impaired (see further comments under Questions 3 and 4).

SPECIFIC COMMENTS ON QUESTIONS RAISED

Question 1 – Definition and additional guidance

The proposed IFRS includes definitions of exploration for and evaluation of mineral resources, exploration and evaluation expenditures, exploration and evaluation assets and a cash-generating unit for exploration and evaluation assets. The draft IFRS identifies expenditures that are excluded from the proposed definition of exploration and evaluation assets. Additional guidance is proposed in paragraph 7 to assist in identifying exploration and evaluation expenditures that are included in the definition of an exploration and evaluation asset (proposed paragraphs 7 and 8, Appendix A and paragraphs BC12-BC14 of the Basis for Conclusions).

In general, we support the definitions provided in ED 6. However, we would like to highlight that the inclusion of a definition of "*exploration for*" and "*evaluation of*" mineral resources, and the exclusion of certain expenditure from exploration and evaluation assets as indicated in paragraph 8, may result in certain types of expenditure capitalised under an existing accounting policy falling outside the definition in ED 6, as a result of an asset currently being capitalised having a wider definition than that used in the proposed standard. More implementation guidance is needed to illustrate how ED 6 should then be applied. For example, should an entity 'split out' the costs that may fall outside the definition and adjust retrospectively or can the definition be applied prospectively so that costs 'incorrectly' capitalised will not be restated?

We would like to see more guidance on the distinction between *"exploration for"* and *"evaluation of"* mineral resources and also guidance as to which exploration and evaluation assets should be capitalised. We believe that paragraph 7 is incomplete as it provides a number of specific examples of exploration type activities, but provides no guidance as to what might constitute *"activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource"* – refer item (f) of paragraph 7. We believe it would be more useful to provide guidance on types of evaluation activities that fall within the definition, and we suggest the use of the following examples:

- Determination of the volume and grade of the mineral resource;
- Determination of appropriate extraction methods; and
- Treatment processes, and consideration of infrastructure requirements.

Guidance should be provided on what constitutes a decision that would change the accounting methodology from the point when development commences. Such guidance should focus on ensuring entities choose a consistent point where evaluation is considered to be complete and development is ready to begin. Without this guidance, entities may choose arbitrary points that may lead to a lack of comparability in relation to applying other IFRSs between entities in the extractive industries.

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

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

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

Are these proposals appropriate? If not, why not?

We support these proposals as an interim measure until such time as the IASB is able to complete its comprehensive project on the issues.

However, ED 6 is not clear on the election of the accounting policy to recognise and measure exploration and evaluation assets in certain situations. For example, we may find entities in one of the following situations:

- There is no guidance on how new entities with no existing accounting policies are to formulate an accounting policy for exploration and evaluation assets.

- If one entity were to acquire another entity as a result of a business combination, it is not clear whether the acquirer's accounting policy can be used in accounting for the subsidiary, where the subsidiary's accounting policies provide more relevant financial statements than that of its new holding company.

We are concerned that the introduction of IFRS will not improve the financial reporting of entities that had inadequate or inappropriate accounting policies prior to the implementation of IFRS. Examples of such policies are where entities capitalised a certain proportion of costs based on their expectation of a successful outcome from the exploration and evaluation activities. Such policies are not consistent with the framework, and the proposed standard encourages entities to continue applying such policies rather than to re-evaluate the appropriateness of such accounting policies. As noted in our general comments, while we do not believe these outcomes are appropriate, we accept that they are necessary as a temporary measure until such time as a comprehensive project is completed.

BC29 states that entities are encouraged to improve their accounting policies. We believe it will be very difficult to determine whether a proposed new accounting policy results in more relevant information (as required by IAS 8 paragraph 14) in a period when no guidance is provided as to what accounting policies provide relevant and reliable information in relation to the extractive industries. In particular, we are concerned that where existing accounting requirements in certain jurisdictions allow alternative treatments, it is not clear how to assess whether a change between the (currently) allowed alternatives would be considered to be an improvement in accounting policy. Consideration of the hierarchy of accounting pronouncements in IAS 8 would not assist users in concluding on the appropriateness of this change.

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

[Draft] IAS 36 requires entities to test non-current assets for impairment. The draft IFRS would permit an entity that has recognised exploration and evaluation assets to test them for impairment on the basis of a 'cash-generating unit for exploration and evaluation assets' rather than the cash-generating unit that might otherwise be required by [draft] IAS 36. This cash-generating unit for exploration and evaluation assets is used only to

test for impairment exploration and evaluation assets recognised under proposed paragraph 4 (see proposed paragraphs 12 and 14 and paragraphs BC15-BC23 of the Basis for Conclusions).

Are the proposals appropriate? If not, why not? If you disagree with the proposal that exploration and evaluation assets should be subject to an impairment test under [draft] IAS 36, what criteria should be used to assess the recoverability of the carrying amount of exploration and evaluation assets?

We agree with the principle of subjecting exploration and evaluation assets to impairment testing. We are, however, concerned that testing for impairment on the basis of a cash-generating unit for exploration and evaluation assets may favour entities engaged in both mining operations and exploration as they will be able to mix the cash flows from their mining operations and potentially strong exploration properties. The effect could be to 'shelter' the capitalised exploration and evaluation expenditure relating to weak or unproven exploration properties, that otherwise would be expensed.

We are further concerned by the proposed methodology, which might be interpreted to imply that the exploration and evaluation assets do not have a recoverable amount in their own right. Our understanding is that the draft standard requires, where the entity elects to test for impairment on the basis of a cash-generating unit for exploration and evaluation activities, that an entity assess a cash-generating unit for impairment under IAS 36 in the standard manner, and then adds the exploration and evaluation assets to the assets being tested. Thus, in completing a value in use analysis, the entity would typically add no additional amount, in respect of the exploration and evaluation asset, to the originally assessed value in use of the cash-generating unit. As a result, where the cash-generating unit is assessed for impairment based on the value in use model, the exploration and evaluation asset may be impaired even though it has a quantifiable selling price.

We believe that illustrative examples of how the impairment test is expected to work in practice (including application of the proposed indicators) will assist users in interpreting the standard. We also believe the IASB should further clarify how a 'pure exploration' company should apply the requirements as it may be difficult for these companies to justify the capitalisation of any exploration expenditure, whereas up to now, that may not be the accounting treatment used.

The IASB should consider alternative approaches for identifying the maximum portion of an entity that may be included as a cash-generating unit for exploration and evaluation assets as a segment may not always be an appropriate cash-generating unit. We believe that if the IASB decides to proceed with the segment approach, the proposed standard should clarify the principle that a cash-generating unit is no bigger than a segment.

The standard should also clarify whether the election of a cash-generating unit in paragraph 14 is a once-off policy choice and, if not, the proposed standard should specify the principles to apply before an entity makes changes to the cash-generating unit.

Although the principle on reversal of impairment losses has been addressed in the basis for conclusions, we believe that it should be incorporated into the main body of the proposed standard. Illustrative examples explaining the implications on reversals and how these are allocated between the different cash-generating units will also be helpful.

The requirement in IAS 36, paragraph 37, to consider only the "*current condition*" of exploration assets in estimating future cash flows is particularly onerous. This will render many exploration assets impaired since value in use without taking into account further capital expenditure on exploration of reserves will often be less than carrying value. We suggest that the proposed standard should include appropriate reference to paragraph 35 of IAS 36 which permits certain future capital expenditure on exploration activities within the cash-generating unit to be included in the cash flow estimate and should provide additional clarity on the application of these two paragraphs (35 and 37) to exploration and evaluation assets.

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

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

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

In our view the indicators are appropriate, but would like to suggest the following additional indicator: "*Government imposes legislation that has an impact on the future profitability of operations in a particular country, for example the imposition of royalty taxes.*"

Question 5 – Disclosure

To enhance comparability, the draft IFRS proposes to require entities to disclose information that identifies and explains the amounts in its financial statements that arise from the exploration for and evaluation of mineral resources (proposed paragraphs 15 and 16 and paragraphs BC32-BC34 of the Basis for Conclusions).

Are the proposed disclosures appropriate? If not, why not? Should additional disclosures be required? If so, what are they and why should they be required?

We agree that the proposed disclosures are appropriate, however, we have a few further recommendations:

- We believe that where an entity capitalises exploration and evaluation costs, a reconciliation of the opening balance of amounts capitalised to the closing balance of amounts capitalised should be required. This requirement is consistent with other assets such as property, plant and equipment, and intangible assets.

- Consideration should also be given to non-financial disclosures that explain exploration activities in general.

- The disclosure of accumulated exploration and evaluation costs by segment to assist the user in assessing the extent of any 'sheltering' of exploration and evaluation assets within a segment.

OTHER COMMENTS

In our view the application of the draft standard to only address exploration and evaluation activities does not address other significant issues that arise in the extractive industries, such as accounting for development activities, for which guidance would be useful to ensure consistent information. We suggest that the scope paragraph also clarifies which issues are specifically not dealt with in ED 6.

EDITORIAL SUGGESTIONS

Paragraph 6 – *"Exploration and evaluation assets should <u>initially</u> be measured at cost"* (consistent with wording in IAS 16 and 38).

Paragraph 8 (b) – *"administration and other <u>non-attributable</u> general overhead costs"* (consistent with principles in IAS 16 and 38).

COMMENT LETTER OF THE EXTRACTIVE INDUSTRIES PROJECT GROUP OF (SAICA) ON ED 6

The project group is an industry interest group, which is represented by preparers, regulators, mineral valuators and industry auditors with extensive experience in the mining industry. This project group considers accounting, auditing and reporting matters of relevance to the industry in South Africa and also has experience in the application of International Financial Reporting Standards (IFRS) for the mining industry.

GENERAL COMMENTS

The project group, in the main, does not support ED 6 for the following reasons:

- The proposed standard does not improve the comparability of entities already reporting under IFRS, as the guidance provided is very limited (see our comments under Question 1).

- The project team does not support the proposed exemption from the hierarchy as it may result in the inappropriate recognition of assets (see our comments under Question 2).

- We are concerned that the impairment test (even for a cash-generating unit for exploration and evaluation assets) will result in companies having to impair assets previously recognised (see our comments under Question 3).

The project group also wants to emphasise that the input into the previous Extractive Industries Issues Paper, issued in 2000, should not be ignored in taking the Extractive Industries project forward. The Issues Paper and comments should be used as basis for any follow-up work and updated with other current industry issues.

SPECIFIC COMMENTS ON QUESTIONS RAISED

Question 1 – Definition and additional guidance

The proposed IFRS includes definitions of exploration for and evaluation of mineral resources, exploration and evaluation expenditures, exploration and evaluation assets and a cash-generating unit for exploration and evaluation assets. The draft IFRS identifies expenditures that are excluded from the proposed definition of exploration and evaluation assets. Additional guidance is proposed in paragraph 7 to assist in identifying exploration and evaluation expenditures that are included in the definition of an exploration and evaluation asset (proposed paragraphs 7 and 8, Appendix A and paragraphs BC12-BC14 of the Basis for Conclusions).

The project group is of the view that the definitions are appropriate, but that the guidance on the treatment of this expenditure is not sufficient. It is still not clear when an exploration and evaluation asset should be recognised and the proposed standard does not improve comparability between companies already reporting under IFRS.

We further believe that, going forward, relevant definitions should be formulated by specialists in the field that would be generally accepted by extractive industries worldwide.

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

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

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

Are these proposals appropriate? If not, why not?

No, the project team believes that many extractive industry companies (specifically in South Africa) already comply with IFRS and that it is not necessary to provide any guidance at this point in time (without proceeding with a full comprehensive project for extractive industries).

The question to be addressed is if an entity acquired something of value and if not, the costs incurred should be expensed.

The project team supports the alternative view as summarised in the appendix to the basis for conclusions.

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

[Draft] IAS 36 requires entities to test non-current assets for impairment. The draft IFRS would permit an entity that has recognised exploration and evaluation assets to test them for impairment on the basis of a 'cash-generating unit for exploration and evaluation assets' rather than the cash-generating unit that might otherwise be required by [draft] IAS 36. This cash-generating unit for exploration and evaluation assets is used only to

test for impairment exploration and evaluation assets recognised under proposed paragraph 4 (see proposed paragraphs 12 and 14 and paragraphs BC15-BC23 of the Basis for Conclusions).

Are the proposals appropriate? If not, why not? If you disagree with the proposal that exploration and evaluation assets should be subject to an impairment test under [draft] IAS 36, what criteria should be used to assess the recoverability of the carrying amount of exploration and evaluation assets?

If the 'grandfathering' of accounting for exploration and evaluation assets as suggested in the proposed standard is retained, the impairment test may put entities in the same position as if no asset was recognised in the first place. For example, a junior exploration company with only exploration and evaluation assets will not have a cash-generating unit and as a result, the exploration and evaluation assets would probably be impaired. Thus, the project group is concerned that the 'grandfathering' objective of ED 6 may not be achieved if the impairment test is retained.

The project group recommends that the principles in the framework should be used to determine initial recognition of exploration assets, as the impairment test is very subjective and difficult to perform.

The cash-generating unit for exploration and evaluation assets may also be abused by larger entities if they allocate these assets to larger cash generating units (to avoid impairment) without there being substance in carrying them as assets in the first place. Without the current guidance in the proposed standard, those 'assets' would probably not have been recognised in the first place.

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

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

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

In our view the indicators are appropriate and that any additional guidance is useful.

Question 5 – Disclosure

To enhance comparability, the draft IFRS proposes to require entities to disclose information that identifies and explains the amounts in its financial statements that arise from the exploration for and evaluation of mineral resources (proposed paragraphs 15 *and 16 and paragraphs BC32-BC34 of the Basis for Conclusions).*

Are the proposed disclosures appropriate? If not, why not? Should additional disclosures be required? If so, what are they and why should they be required?

The project group supports the additional disclosure and notes that detailed disclosure on exploration and evaluation assets is valuable to users of financial statements.

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