Oil Industry Accounting Committee

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Colin Fleming
International Accounting Standards Board
30 Cannon Street
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16 April 2004

Dear Mr Fleming

ED6 – Exploration for and Evaluation of Mineral Resources

The Oil Industry Accounting Committee ("OIAC") is pleased to submit its comments on the IASB's exposure draft "ED6 – Exploration for and Evaluation of Mineral Resources" together with its responses to the specific questions on which the IASB invited comment, set out in the Appendix to this letter.

OIAC is recognised by the UK Accounting Standards Board ("ASB") for the purposes of issuing Statements of Recommended Practice ("SORPs") for the upstream oil and gas sector. Under UK accounting standards, entities with activities in the upstream oil and gas sector are required to refer specifically to OIAC's SORP, state whether their financial statements comply with it, and justify any departures from it.

OIAC fully supports the objective identified in paragraph 1(a) of ED6, which is to make limited improvements to accounting practices, without requiring major changes that may be reversed when the Board undertakes a comprehensive review. In the absence of a standard based on ED6, oil and gas exploration and production ("E&P") entities would be able to refer only to generally applicable guidance in IFRS and the IFRS framework, and OIAC believes that a spectrum of differing accounting practices, based on a range of differing interpretations of IFRS requirements, would result. At present, whilst there are admittedly two distinct prevalent methods of accounting in the E&P sector – the "full cost" and "successful efforts" methods – both are well established in the UK and internationally, consistently applied and well understood by users of financial statements. OIAC believes that existing consensus around these two methods should be preserved, at least until such time as the IASB undertakes its comprehensive review.

OIAC also agrees that an entity should assess at each balance sheet date whether there is any indication that an exploration and appraisal asset may be impaired. However, OIAC is concerned that the use of the word "test" in paragraphs 1(b) and 14 could be misunderstood in our industry, where the terminology "impairment test" or "ceiling test" has been used for many years. We have suggested alternative words consistent with IAS36 to avoid the risk that ED6 could be misinterpreted as requiring an annual comparison of the carrying amount against the recoverable amount, irrespective of whether or not the information sources proposed in paragraph 13 suggest any indication of impairment.

Furthermore, OIAC believes that the words "generates cash flows from continuing use" used in the definition of a cash generating unit for exploration and evaluation impairment calculations render the definition inappropriate, and therefore they should be deleted from the definition.

OIAC is supportive of requiring such disclosures as are necessary to assist users in comparing between different treatments of exploration and evaluation expenditures. However, such disclosures should not be excessive in scope and detail.

As you will see from the Appendix, OIAC has also made some supplementary recommendations in areas not directly covered by the ED6 questions. These cover the proposed standard's applicability to new start-up companies and in the event of business combinations, and a concern that IAS36 could lead to exploration and evaluation asset impairment provisions being reversed in certain circumstances. The latter would be a significant change to existing established practice and OIAC has suggested a possible solution within ED6.

Whilst ED6 addresses only exploration and evaluation assets, OIAC would encourage the IASB to give priority to its comprehensive review for entities engaged in oil and gas E&P activities. For example, both UK and US GAAP have long recognised the importance of specific accounting and disclosure issues, such as the estimation and disclosure of reserves quantities, that will not yet form any part of IFRS. We have some doubts that there is sufficient common ground between oil and gas E&P and the mining and minerals extraction industries for a single standard covering all extractive industries to be practical. As a minimum, therefore, OIAC would like to see any future IASB extractive industries project team with a strong representation of experienced E&P industry representatives from the US and UK, where industry-related accounting standards and guidance have been in place for many years.

If you have any questions concerning our comments, please do not hesitate to contact me at the telephone number or email address shown above.

Yours sincerely

Alan Thomas

Chairman, Oil Industry Accounting Committee

Appendix – Responses to specific questions

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)."

OIAC agrees that the categories of expenditures listed in paragraph 7 of the exposure draft are suitable for deferral. However, OIAC suggests that the Board clarifies that the items listed in paragraph 7 represent examples of eligible expenditure within the definition at Appendix A, rather than an exhaustive list. Otherwise some companies may interpret a need to change their previous policies, where none was intended by IASB.

Paragraph 8(b) of the draft IFRS states that "*administration and other general overheads*" shall not be included in the initial measurement of exploration and evaluation assets. Consistent with the requirements of IAS 16, Property, Plant and Equipment, OIAC believes that paragraph 8(b) should be modified so that administration and other general overheads shall not be included the cost of an exploration and appraisal asset *unless they can be directly attributed to the exploration and evaluation asset.* Without this addition some companies may interpret from ED6 a need to change their previous practice, where none would be required in the relevant IFRS.

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

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

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

Are these proposals appropriate? If not, why not?"

At present, there is a high level of consensus around the 'full cost' and the 'successful efforts' methods, which are well established, consistently applied and well understood in the E&P sector, both within the UK and internationally. OIAC strongly believes there is substantial benefit in preserving such consensus until comprehensive IFRS guidance for the extractive industries is in place.

OIAC is concerned that in the absence of specific IFRS guidance, and without the exemptions proposed in ED 6, comparability between companies in the E&P sector would be diminished, rather than enhanced. OIAC believes that reporting entities in the E&P sector would move to a spectrum of differing accounting treatments, based on differing interpretations of IFRS requirements, because existing generally applicable IFRS requirements are insufficiently specific to ensure consistency of application.

OIAC therefore agrees that limited interim measures are required for the extractive industries to preserve the benefits of existing practice, until a rigorous and comprehensive project on accounting and financial reporting for the E&P sector can be completed. Accordingly, OIAC supports the exemptions proposed in paragraphs 4 and 5 of ED6.

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?"

OIAC is supportive of the Board's objectives as set out in its Basis of Conclusions paragraphs BC16 to BC 20. However, OIAC is concerned that ED6 may not give effect to those objectives in two key respects as explained in the paragraphs below.

Firstly, the definition requires that a cash generating unit for exploration and evaluation assets is "*the smallest group ... that generates cash flows from continuing use"*.

Since a licence, well or prospect will not initially (and ultimately may never) generate cash flows, the definition appears to require unproved exploration and evaluation assets to be grouped with other properties where commercial reserves have already been established in order that the cash generating unit for exploration and evaluation can be said to *"generate cash flows from continuing use"*.

Consequently, some entities, specifically successful efforts entities, would be required to assess impairment of properties in the exploration and evaluation stage only at a significantly more aggregated level than is currently the case. This would appear to be inconsistent with the Board's Basis of Conclusions. It would also represent a significant departure from existing UK and US practice, and would tend to allow the cost of unsuccessful exploration remaining capitalised on the balance sheet where existing practice would have written it off. OIAC recommends that the words "*generates cash flows from continuing use*" be deleted from the definition, to enable impairment assessments to be applied at a less aggregated level.

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OIAC is also concerned that the use of the word *"test"* throughout ED6, in particular in paragraphs 1(b) and 14, could imply to some that the carrying value of exploration and evaluation assets must be reduced to an estimate of the net present value of future cash flows on an annual basis – effectively requiring such assets to be written down almost as soon as they are recognised. This would appear contrary to the Board's Basis of Conclusions. OIAC recognises that using the word "test" may only be a source of misunderstanding in the oil and gas industry, where the terminology "impairment test" or "ceiling test" has been in routine use for many years to describe the entire process of assessing for and quantifying impairment.

OIAC recommends that the wording of ED6 is clarified and aligned more closely with the wording used in paragraphs 8 and 9 of IAS 36. Specifically, OIAC recommends that the general references to the word "*test*" should be avoided, and instead ED6 should be explicit as to the following:

1. An entity should <u>assess</u> at each balance sheet date <u>whether there is any indication that an exploration and evaluation asset may be impaired</u>, (taking into consideration the specific sources of information proposed in ED6 paragraph 13).

2. If <u>and only if</u> any such indication exists, the entity should estimate the recoverable amount of the exploration and evaluation asset, and reduce the carrying value to the recoverable amount if it is less. It follows that if no indication of impairment is identified, then it is not necessary to proceed to estimate net selling price or value in use.

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?"

OIAC concurs that sufficient information should be disclosed in the financial statements to enable users to make high level adjustments for the effects of different accounting policies for exploration and evaluation, to facilitate comparison.

The Board might also consider providing illustrative examples of the disclosures required in order to encourage the provision of high quality and transparent information pending the completion of the comprehensive project.

Additional comments

Business combinations

Acquisitions and disposals of entities are relatively common within the oil and gas industry, as entire groups are taken over, or oil and gas properties changes hands by transferring the legal entities which hold them.

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OIAC believes that an acquired entity which follows IFRS in its local statutory financial statements should be specifically permitted to amend its accounting policies for exploration and evaluation in order to adopt the IFRS accounting policies of the new controlling party.

OIAC also considers that ED6 should clarify the appropriate recognition and measurement at fair value of exploration assets acquired as part of a business combination.

Start up businesses
OIAC notes that an entity engaging in exploration and evaluation activities for the first time would not be in a position to take advantage of the proposed exemption in ED6 - because it will have no previous accounting policies to continue.

OIAC recommends that such entities should be permitted under the exemption to adopt a set of accounting policies which represent generally accepted practice in its industry sector and jurisdiction.

Reinstatement of previously impaired exploration costs
OIAC observes that IAS 36 would appear to require that a previous impairment provision against an exploration and evaluation asset would be reinstated by the entity as a credit to income in the event that subsequent events indicated that the prospect was in fact no longer impaired.

Examples of such circumstances might include unforeseen access to nearby infrastructure rendering a previously uncommercial discovery commercial, or an improvement in the long term view of oil and gas prices.

Reversal of past exploration cost write offs would represent a departure from existing industry practice. OIAC considers that recognition of such a reversal would be inappropriate for properties which are still at the exploration and evaluation stage, and recommends that the IASB considers an exception from recognising an impairment reversal, equivalent to that in existence in IAS 36 for goodwill.