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TECH 14/04

ACCOUNTING UNDER IFRS IN THE EXTRACTIVE INDUSTRIES

Memorandum of comment submitted in April 2004 to the International Accounting Standards Board concerning the exposure draft ED 6, 'Exploration for and Evaluation of Mineral Resources'

Contents **Paragraphs**

INTRODUCTION

1. The Institute of Chartered Accountants in England & Wales welcomes the opportunity to comment on the exposure draft ED 6, ‘*Exploration for and Evaluation of Mineral Resources*’, published for comment in January 2004 by the International Accounting Standards Board (‘the Board’). The Institute is the largest accountancy body in Europe, with more than 125,000 members operating in business, public practice and within the investor community. The Institute operates under a Royal Charter, working in the public interest.

2. We have reviewed the exposure draft and set out below a number of comments and suggestions for consideration by the Board. We deal first with significant matters before commenting on the specific issues raised in the consultation paper.

3. We have copied this letter for information to the UK Accounting Standards Board, the European Financial Reporting Advisory Group and the UK Department of Trade and Industry.

MAJOR POINTS

Support for the Proposals

4. We strongly agree that interim measures are needed for entities in the extractive industries required to apply International Financial Reporting Standards (IFRS) from 2005. Such measures are required to facilitate an orderly transition to IFRS in view of the multiplicity of generally accepted accounting practices in the extractive industries, and lack of agreement on their relative merits.

5. The Board’s approach in the proposed IFRS is to permit entities engaged in the exploration for and evaluation of mineral resources to elect to continue their existing accounting policies for such activities in defined circumstances. This is a major concession, but one that we support in the circumstances. However, our support for this approach is conditional on an acceleration of the proposed comprehensive project on accounting and financial reporting in the extractive industries. We consider it very important for the Board to devote substantial resources to the project and to aim to publish a comprehensive IFRS for the sector by 2007. We comment in greater detail on this matter below in our response to Question 2.

The Need for Clarity

6. A primary concern of businesses preparing to apply IFRS for the first time in 2005 is the need for certainty regarding applicable accounting requirements. We explain below in our response to Question 2 that:

- the Board’s encouragement to entities that take advantage of the proposed concessions ‘to improve their accounting policies’ (paragraph BC29) might appear inconsistent with the underlying purpose of the draft IFRS; and

- the current structure of the draft IFRS does not set out clearly the options available to reporting entities.

7. In addition, for the avoidance of doubt it should be clearly stated in the new IFRS that its provisions do not cover assets and operations beyond the life cycle of exploration assets.

Impairment

8. We have serious concerns regarding the requirement for all entities to perform an annual impairment test in line with draft IAS 36, albeit one with an amended definition of a cash-generating unit (CGU). The nature of exploration and evaluation assets means that the preparation of reliable projections of future cash flows is often impracticable, and such assets are not readily identifiable with other assets that make up a specific CGU. We are not convinced that the concessions made in the draft IFRS will achieve the Board's objective of avoiding widespread changes to accounting policies in the extractive industries.

9. To ensure that current practices may continue pending the comprehensive review of accounting in the sector, the Board should consider further specific changes to the requirements of draft IAS 36, as explained below in our response to Question 3, and might conclude that clarity would be best served by providing a temporary exemption from IAS 36 for exploration and evaluation assets.

Disclosures

10. We strongly support a requirement in the proposed IFRS for enhanced disclosures as a *quid pro quo* for permitting interim accounting arrangements for the extractive industries.

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).

11. We agree that clear international definitions of exploration and evaluation for accounting purposes are necessary to underpin the draft IFRS, as local definitions may vary considerably. We broadly support the definitions set out in Appendix A to the draft IFRS, although reference to the distinction between *pre-exploration costs* and *exploration costs* might be helpful.

12. We agree that the categories of expenditures listed in paragraph 7 of the exposure draft are suitable for deferral. However, it is unclear whether this paragraph simply provides examples, or instead provides guidance that develops the definitions set out in Appendix A. We suggest that the Board clarifies that the items listed in paragraph 7 are examples of expenditure that satisfy the definitions, rather than an exclusive list of eligible expenditure.

13. Paragraph 8 of the draft IFRS clarifies the types of expenditure that should not be included in the initial measurement of exploration and evaluation assets. We agree that it is generally appropriate to exclude administration and other general overhead costs. However, clarification is required of whether directly attributable administrative and overhead costs, for example incremental employee, legal and office expenses, should be excluded. The distinction between items that may and may not be capitalised might be clearer if reference is made to the concept of costs 'directly attributable' to a project (as used in IAS 16, *Property, Plant and Equipment).*

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?

Support for the Proposals

14. We agree that limited interim measures are required for the extractive industries as a rigorous and comprehensive project on accounting and financial reporting cannot be completed in time for implementation in 2005. Accounting practices within the extractive industries are diverse and at present there is no

international consensus on the most appropriate accounting treatment of exploration and evaluation expenditure. This is highly unsatisfactory - the degree of variation in accounting practice undermines the relevance and usefulness of financial reporting in the sector. However, there is at least a reasonable level of consensus around certain key principles, in particular the 'full cost' and the 'successful efforts' methods, which are widely-accepted and well-understood in the oil and gas sector. It would be beneficial to preserve consensus where it exists until a comprehensive IFRS framework for the extractive industries can be put in place.

15. Subject to our comments in paragraph 17 below, we support the approach adopted in the exposure draft of allowing entities engaged in the exploration for and evaluation of mineral resources to elect to continue their existing accounting policies for such activities in defined circumstances, as an alternative to applying the hierarchy in IAS 8. It would be unhelpful to introduce more extensive changes in the short-term; the benefits to users of any improvement in comparability - itself not an inevitable outcome - would be unlikely to outweigh the costs and disruption of introducing changes that companies may well have to reverse on completion of the Board's comprehensive project.

16. We recognise that the proposed concessions in the draft IFRS will result in a wide range of accounting policies remaining in use in 2005 and therefore no improvement in the existing level of comparability in published financial information. In the United Kingdom, this is particularly the case in the mining sector, for which (unlike the oil and gas sector) no 'Statement of Recommended Practice' exists. Our support for the Board's approach is therefore conditional on the acceleration of the proposed comprehensive project on accounting and financial reporting in the extractive industries. It is noted in paragraph AV4 of the exposure draft that:

'*Although a research project is expected to begin in 2004, it is unlikely that the Board will be able to develop financial reporting standards in the near- to mid-term. Accordingly, it is likely that the proposed concessions will remain in place for some time*'.

This is highly unsatisfactory, particularly as in some jurisdications the extractive industries account for a significant proportion of economic activity. We consider it very important for the Board to devote substantial resources to the project and to aim to publish a high quality and comprehensive IFRS for the extractive industries by 2007.

Improving Accounting Policies

17. Entities that take advantage of the proposed concessions are permitted by paragraph 11 of the draft IFRS to amend their accounting policies for exploration and evaluation if the changes improve the relevance and reliability of the financial statements. However, the primary objective of the proposals is to permit entities to continue to apply existing accounting policies without

having to consider the various sources of authoritative requirements and guidance that might be otherwise be relevant.

18. In these circumstances, the Board's express encouragement in paragraph BC29 to entities that make the election 'to improve their accounting policies' might appear inconsistent and lead to uncertainty amongst preparers. It also appears unhelpful when the Board acknowledges (in paragraph BC10) that there is no international consensus on the most appropriate way to account for exploration and evaluation expenditure. The Board should reconsider its comments in BC29 before issuing the proposals as a standard. It might be helpful to explain that companies are permitted to move to another method of accounting provided it is more consistent with the general principles of IFRS or more widely accepted in the industry. This might allow companies to migrate from 'full cost' to 'successful efforts' - but not *vice versa* - and might provide better guidance for start-up companies seeking to adopt the most appropriate accounting policies.

Non-use of the Election

19. The current structure of the draft IFRS does not set out clearly the options available to reporting entities. Paragraph BC32 explains that entities that do not make the election are required to apply the hierarchy in IAS 8 and goes on to state:

'The Board notes that such an entity should not apply paragraphs 4-10 [on measurement] of the draft IFRS by analogy in developing its accounting policies… because the proposals in the draft IFRS are predicated on the suspension of the criteria in paragraphs 11 and 12 of IAS 8'.

The non-applicability of paragraphs 6-10 to entities that do not make the election should be clear in the IFRS, without reference to the Basis for Conclusions. It should also be clear whether or not paragraphs 11-16 on impairment and disclosure apply to such entities. We recommend inclusion in the IFRS of a clear and prominent explanation of the accounting implications of making - or not making - the election in paragraph 4.

20. Finally, it should be clear that, although, although the exposure draft focuses on impairment issues, an accounting policy of amortisation of cost or revalued amount remains acceptable, whether or not the election is made.

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?

21. We agree that it is important to ensure that assets are not carried at greater than recoverable amount (paragraph BC16) However, as explained below, in the extractive industries it is common practice to begin to capitalise and carry costs before it is possible to measure realistically the recoverable amount. We therefore have serious concerns regarding the requirement for all entities to perform an annual impairment test in line with draft IAS 36, albeit one with an amended definition on a cash-generating unit.

22. The nature of exploration and evaluation assets means that the preparation of reliable projections of future cash flows is often impracticable, and such assets are not readily identifiable with other assets that make up a specific CGU. In both the mining and petroleum industries, there is often a very lengthy interval between initial pre-production activities and the determination of economic reserves. The application of the definition of a CGU in draft IAS 36 (paragraph 5) to test exploration and evaluation assets would result in a high incidence of impairment losses in relation to existing assets.

23. We therefore agree that, as an interim measure, entities should, firstly, only be required to perform a test for impairment by reference to future cash flows if specific indications of potential impairment exist, and, secondly, should be entitled to apply impairment tests for exploration and impairment assets to a higher level of aggregation than is permitted under draft IAS 36. However, we are not convinced that these concessions, as currently worded, will achieve the objectives of the Board, for two principal reasons.

24. Firstly, it is not sufficiently clear in the wording of paragraph 12 that a 'test' for impairment under paragraph 14 is only required if the annual assessment based upon the information sources listed in paragraph 13 suggest that an exploration and evaluation asset may be impaired.

25. Secondly, a requirement for entities in the oil and gas sector applying full cost accounting to segregate and test development costs and cash flows relating to individual fields within cost pools would represent a significant shift in current practice and is likely to lead to the recognition of significant impairment losses in relation to pools on balance sheet at the date of transition. The exemption proposed for the impairment testing of exploration and evaluation assets appears not to cover development costs. Furthermore, full cost companies would experience serious practical difficulties in applying an impairment test on a field-by-field basis to individual fields in the pool because, for example, the balance of accumulated depreciation is computed for the pool as a whole. A requirement to apply impairment tests at the field level may therefore be incompatible with the full cost method. Comparable problems will arise for successful efforts companies when seeking to apply impairment standards to exploration and expenditure assets for the first time.

26. To ensure that accounting practices are not changed unnecessarily before the planned comprehensive review, the Board should consider further changes to the requirements on impairment. For example:

- The requirements set out in paragraph 12 of the exposure draft should be consistent with draft IAS 36, paragraph 8. Paragraph 12 should therefore be amended to require assets to be assessed annually *for indications of* impairment;

- Guidance may be required on some of the implications of applying IAS 36, for example whether amounts written-off in relation to unsuccessful wells should be reinstated when a prospect proves subsequently to be viable (which would be contrary to existing 'successful efforts' practice);

- Paragraph 14 should permit entities first applying the new IFRS to continue to undertake an annual impairment '*assessment* ' or '*review'* - rather than a 'test' - of intangible exploration and evaluation assets; and

- The words '*generates cash flows from continuing use*' should be deleted from the definition in Appendix A of a 'CGU for exploration and evaluation assets'. The definition may otherwise lead companies which currently review exploration and evaluation properties on a property-by-property basis to assume that compliance with the definition requires identification of each group of exploration and evaluation assets with others which have progressed into production and therefore do have cash flows. This would run contrary to the objective of keeping the impairment review at least as specific as it has been in the past.

27. If entities in the extractive industries are required to test assets for impairment in accordance with IAS 36, they should be specifically permitted to take account of future capital expenditure plans to the extent that they are necessary to gain access to the reserves identified through exploration and evaluation, and hence gain access to the related cash flows. Draft IAS 36, paragraph 37, requires future cash flows to be estimated for *assets in their current condition*, excluding consideration of future capital expenditure. In the context of exploration and evaluation expenditure, this is inappropriate, at least pending the comprehensive review. An assessment of future expenditure plans will be essential to underpin any realistic assessment of cash flow opportunities.

28. Finally, we suggest that the Board clarifies in paragraph 14 that the 'CGU for exploration and evaluation assets' should not be at a higher level than the CGUs used in connection with the most recent annual financial statements.

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?

29. We agree that it necessary to set out additional indicators of impairment for entities seeking to identify whether exploration and evaluation assets might be impaired. The indicators identified by the Board in paragraph 13 of the exposure draft are appropriate, although it might be useful to highlight the central importance of clear management commitment, assessed annually and based on commercial and technical analysis, to future exploration and evaluation. In many cases, projects in the extractive industries take many years to come to fruition. If there has been no substantial activity (and no clear intention of management to undertake such activity) relating to the prospect, there should be a presumption that deferred costs should be charged to profit and loss account.

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?

30 We strongly support a requirement in the proposed IFRS for enhanced disclosures as a *quid pro quo* for permitting interim accounting arrangements for the extractive industries.

31. The requirement to disclose separately the expenditure written off in the income statement during the accounting period is important and should be stated more clearly in the final IFRS. 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.

nsj/ 15 April 2004