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International Accounting Standards Board
30 Cannon Street, London
EC4M 6XH, United Kingdom

Attention: Colin Fleming

Dear Sirs:

Re: Exposure Draft ED 6 Exploration for and Evaluation of Mineral Resources

The Petroleum Accountants Society of Canada (PASC) is pleased to respond to the request for comments from the International Accounting Standards Board (the "IASB" or the "Board") on its ED 6 *Exploration for and Evaluation of Mineral Resources* ("ED 6"). We are very supportive of the Board's efforts to harmonize accounting principles for the extractive industries and look forward to assisting the IASB in any manner possible. This letter, the content of which was developed primarily by our Financial Accounting Research Committee ("Committee"), focuses on oil and natural gas production as it relates to ED 6. This letter represents the consensus of the Committee members and has been approved by the PASC Board of Directors.

As you may be aware, there are currently two models of accounting for oil and natural gas exploration and production that companies may choose to follow: Full cost accounting (as defined in Accounting Guideline 16 *Oil and Gas Accounting – Full Cost* ("AcG 16") published by The Canadian Institute of Chartered Accountants ("CICA")) and successful efforts (as defined in Statement of Financial Accounting Standard ("SFAS") 19 *Financial Accounting and Reporting by Oil and Gas Producing Companies* (as amended) published by the Financial Accounting Standards Board of the United States of America). Choosing one of these methods, or a new model with various elements of each, would have a significant impact on the financial statements of oil and natural gas exploration and production companies in Canada. Overall, we agree that one method of accounting is desirable, would provide better comparability among companies and would be better understood by readers of financial statements.

We noted ED 6 relates only to the exploration for and evaluation of mineral resources and that companies following International Accounting Standards are allowed to follow the method of accounting for other activities previously followed.

Responses to Specific Questions

Following are our responses to specific questions posed in ED 6. We have provided the question number and title only.

Question 1 – Definition and additional guidance

Costs included and excluded

PASC believes that the definitions are generally satisfactory. To avoid confusion regarding definitions, we would suggest that the words "subject to limitations described in paragraph 8" be added to the end of paragraph 7(f). Our concern is that the term "activities" in paragraph 7(f) may be interpreted to include administration and general overhead costs. Although paragraph 8(b) states that such costs should not be included in "the initial measurement of exploration and evaluation assets," some may argue that 7(f) allows such costs.

Cash-generating unit

ED 6 defines a cash-generating unit as "the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets." Companies that have adopted successful efforts are required to evaluate oil and gas assets by grouping assets that are similar in nature. Often a producing field or geological formation would define this group of assets. Under successful efforts accounting, these smaller cash-generating units would be assessed for impairment on an individual basis. This does not apply to full cost accounting where the only cash-generating unit is the country, both in Canada under AcG 16 and in the United States (Rule 4.10 of Regulation S-X of the Securities and Exchange Commission).

Therefore companies that have adopted successful efforts accounting are already in compliance with ED 6. Companies using a full cost method would essentially end up with a *hybrid* if they were to implement the standards in ED 6. To evaluate oil and gas assets using a cash-generating unit model would not be recommended unless the successful efforts methodology is exclusively adopted in the oil and gas industry.

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

These proposals are appropriate because the Board has been unable to determine one overall standard without further research and evaluation. Companies are allowed to continue using the same accounting policy that they have incorporated in the past until a new standard is developed. This ensures consistency exists with the company and there will not be subsequent changes because a decision has not been made. In light of there not being a consensus, it is best to keep status quo.

Unfortunately, a standard still does not exist between reporting countries. Companies are allowed to use different methods and when evaluating assets, this becomes another reconciling item for comparison purposes. Companies cannot be evaluated equally without dissecting the effects of the accounting policy used.

Question 3 – Impairment testing for exploration and evaluation costs

We agree that exploration and evaluation costs should be subject to an impairment test. ED 6 specifies that the impairment test to be used is that in International Accounting Standard 36 ("IAS 36"), which requires that impairment be assessed based on indicators specified in the Standard. Impairment is calculated based on the excess of either 1) the net selling price, if one can be determined, or 2) value in use over the carrying value of the asset. Value in use is defined as discounted cash flow from the continuing use of the asset. The discount rate to be used must be either one that incorporates the risks specific to the asset or a surrogate rate incorporating country risk, currency risk, price risk, and cash flow risk.

This approach is similar to a traditional present value technique where a single (best estimate) of cash flows is discounted at a single interest rate, commensurate with risk. This takes a somewhat different approach from a fair value approach using an expected present value technique, which adjusts cash flows for risk and then uses a risk-free rate to discount them. Theoretically the result should be the same as all risks are incorporated into the calculation either by adjusting the cash flows or in the discount rate, but differences could arise in practice due to uncertainties in how risk is taken into account; a process would be needed to ensure that all aspects of risk are accounted for in either the cash flows or the discount rate, and to avoid the double-counting of risk through adjustment of both the cash flows and the discount rate for the same elements of risk. Additionally, IAS 36 specifies that the discount rate would take into account certain enterprise-specific factors such as the weighted-average cost of capital and incremental borrowing rate.

For oil and gas exploration and production companies, risk is often factored into the cash flows as a result of the oil and natural gas reserve determination process. In Canada, reserves determination is governed by National Instrument 51-101 *Standards of Disclosure for Oil and Gas Activities* effective September 30, 2003. In this instance, an expected present value technique would therefore be more appropriate.

A further aspect of ED 6 is that the unit to be used for impairment testing may in some cases conflict with existing accounting practices, as noted in our comments on question 1 above. In a situation where a company following the full cost method has several projects in one country, all of which generate discrete cash flows independently of each other, this provision of ED 6 could require separate tests for each property, whereas the impairment under full cost (Canada and the United States) would be applied on a country basis.

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

IAS 36 provides guidance (indicators) on identifying assets that may be impaired and requires an entity to consider specified external sources of information. These indicators, as noted in IAS 36, are:

1. 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;

2. Further exploration for and evaluation of mineral resources in the specific area are neither budgeted nor planned for in the future;

3. Significant changes with and adverse effect on the main assumptions, including prices and foreign exchange rates, underlying approved budgets or plans for further exploration for and evaluation of mineral resources in the specific area;

4. The decision not to develop the mineral resource in the specific area has been made;

5. The entity plans to dispose of the asset at an unfavourable price; and

6. The entity does not expect the recognized exploration and evaluation assets to be reasonably capable of being recoverable from a successful development of the specific area, or by its sale.

Additional guidance may be included in respect of item 3 along with some examples, without limiting the generality of point. For example:

- Staffing changes (layoffs, attrition, etc.) that may affect future development plans;
- Surface issues – human population or business enterprises (future development of a city or town); and
- Changes in government policy

One should also keep in mind emerging technologies to extract hydrocarbons.

Question 5 - Disclosures

ED 6 Paragraph 16(a) requires a company to "disclose accounting policies for exploration and evaluation expenditures including the recognition of exploration and evaluation assets."

We agree with this proposal as it is useful information for the reader and consistent with current accounting literature.[1] Without providing the reader this information, the financial statements would be of limited use.

ED Paragraph 16(b) requires companies to "disclose the amounts of assets, liabilities, income and expense (and, if it presents its cash flow statement using the direct method, cash flows) arising from the exploration for and evaluation of mineral resources."

In confining itself to the exploration for and evaluation of mineral resources, the proposal in paragraph 16(b) may conflict with disclosures currently required by US SFAS 19 (together with SFAS 69 *Disclosure About Oil and Gas Producing Activities*), US SFAS 131 *Disclosures About Segments* and CICA Handbook section 1701 *Segment Disclosures*. SFAS 19 creates disclosure criteria for what might be a sub-segment in many entities, but in doing so it establishes a materiality threshold below which disclosures are not required (see SFAS 69, paragraph 8 and SFAS 131, paragraph 133(b)). ED 6 does not set a materiality (significance) threshold thereby creating disclosures for items that may be reported as part of a natural resources segment and that may potentially be insignificant for some entities.

ED Paragraph 16(c) requires companies to disclose the level at which the entity assesses exploration and evaluation assets for impairment. This requirement is consistent with current accounting literature[2] and would represent useful information to the reader.

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[1] See Accounting Principles Board (US) 22 *Disclosure of Accounting Policies*, SFAS 19 and CICA Handbook section 1505 *Disclosure of Accounting Policies.*

[2] US SFAS 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* and CICA Handbook section 3063 *Impairment of long-lived assets.*

PASC appreciates this opportunity to comment on the IASB's exposure draft and looks forward to working with the IASB in the future.

Yours truly,

PETROLEUM ACCOUNTANTS SOCIETY OF CANADA

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