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Colin Fleming
International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

Email: CommentLetters@iasb.org

Dear Colin

AASB staff submission on IASB ED 6 *Exploration for and Evaluation of Mineral Resources*

In response to the IASB's Invitation to comment on its Exposure Draft ED 6 *Exploration for and Evaluation of Mineral Resources*, the Australian Accounting Standards Board staff have prepared the attached submission.

The AASB issued ED 6 in Australia with a wrap around as ED 130 *Request for Comment on IASB ED 6 Exploration for and Evaluation of Mineral Resources* shortly after the release of ED 6. The wrap around compared the proposals in ED 6 with current Australian requirements in AASB 1022 *Accounting for the Extractive Industries* and encouraged Australian constituents to respond to the IASB on the proposals in ED 6, with copies of those responses to the AASB. AASB staff have prepared their comments after having considered Australian constituents' comments on ED 130.

AASB staff support the IASB's intent for issuing ED 6, which, as stated at paragraph IN2, is to "provide guidance on the treatment of exploration and evaluation expenditures that will enhance comparability between entities while avoiding unnecessary disruption to the application of those treatments, pending more complete consideration of the accounting issues involved". However, AASB staff very strongly disagree with ED 6 as currently drafted because:

- contrary to the stated intent, the proposed impairment testing requirement would result in many exploration companies being required to write-off their capitalised exploration and evaluation costs, which would represent a significant change to their treatment of exploration and evaluation costs;
- the 'cash-generating unit for exploration and evaluation assets' concept, as currently drafted, has a bias towards entities that have cash flows from production as against companies that are still in the exploration phase;

- the approach of 'grandfathering' an entity's existing practice is not consistent with the grandfathering approach applied in IFRS 4 *Insurance Contracts*, which instead permits the grandfathering of national GAAP; and
- the proposals do not necessarily operate to treat like transactions in a like manner.

AASB staff are also very concerned that the IFRS arising from ED 6 is not expected to be released until the fourth quarter of 2004 ("IASB Project Timetable", last updated 1 March 2004). Consequently, entities engaged in exploration and evaluation activities have not been provided with a "stable platform" of Standards to enable them to prepare for an orderly transition to IFRS or IFRS-equivalent Standards from 1 January 2005. However, if the 'grandfathering' is to be effective for countries already committed to adopting IFRSs, it must be available for application from 1 January 2005.

AASB staff hope that their comments in the attached submission, explaining their concerns and those of the AASB's constituents, will assist the IASB when reconsidering the proposals in ED 6.

Yours sincerely

David Boymal
Chairman

Submission of Comments on ED 6 by AASB staff

Overall comment

AASB staff support the IASB's intent for issuing ED 6, which, as stated at paragraph IN2, is to "provide guidance on the treatment of exploration and evaluation expenditures that will enhance comparability between entities while avoiding unnecessary disruption to the application of those treatments, pending more complete consideration of the accounting issues involved".

In that sense, AASB staff support, on pragmatic grounds, the proposal to suspend the IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* hierarchy and allow entities to apply 'grandfathered' accounting policies for the treatment of exploration and evaluation costs.

However, AASB staff very strongly disagree with the proposals in ED 6 as currently drafted for the following key reasons:

- contrary to the stated intent of ED 6, the proposed impairment testing requirement would result in many exploration companies being required to write-off their capitalised exploration and evaluation costs, which would represent a significant change to their treatment of exploration and evaluation costs;
- the 'cash-generating unit for exploration and evaluation assets' (CGU-EEA) concept, as currently drafted, has a bias towards entities that have cash flows from production as it permits unrelated cash inflows to be included in the calculation of recoverable amount of 'exploration and evaluation assets', thereby potentially avoiding an impairment write-down;
- the approach of 'grandfathering' an entity's existing practice is not consistent with the "grandfathering" approach applied in IFRS 4 *Insurance Contracts*, which instead permits the grandfathering of national GAAP. Consequently, new entrants to exploration and evaluation will not be able to apply grandfathered accounting practice (as they have no past practice to grandfather), whereas new entrants that write insurance business will be able to apply grandfathered national GAAP. The AASB believes that the scope and nature of any grandfathering concession should be equivalent in all IFRSs; and
- the proposals do not necessarily operate to treat like transactions in a like manner. For instance, as noted above, the interaction of the grandfathering and impairment testing proposals in ED 6 allows producing entities to carry-forward exploration and evaluation costs that an exploration-only entity must write-off. Furthermore, ED 6 permits existing exploration and evaluation entities to apply grandfathered accounting policies but does not allow 'new entrants' to apply those same grandfathered accounting policies.

The timing for the release of the IFRS arising from ED 6 ('the IFRS') is also a key concern for AASB staff. Not releasing the IFRS until the fourth quarter of 2004 ("IASB Project Timetable", last updated 1 March 2004) means that these entities are not provided with a "stable platform" of Standards to enable them to prepare for an orderly transition to IFRS or IFRS-equivalent Standards from 1 January 2005. Furthermore, AASB staff understand that the effective date of the IFRS may be shifted to 1 January 2006 with an election to early adopt the IFRS from 2005. This is not considered to represent a solution to the late delivery of the IFRS as all entities that wish to access the grandfathering must apply the IFRS at the same time as they first apply IFRSs, which for jurisdictions such as Australia and the European Union will be from 1 January 2005. Instead, AASB staff strongly recommend that:

- ED 6 must be available for application from 1 January 2005; and
- in the meantime, detailed and regular updates on the IASB's deliberations on the ED should be provided, and in particular the updates should indicate areas where the requirements of ED 6 may change.

The adoption of the proposals in ED 6 will represent a significant change in practice for a substantial number of Australian companies (there are in the order of 500 "junior explorers" listed on the Australian Stock Exchange, many of which currently capitalise their exploration and evaluation costs). Given the above concerns regarding the practical effect of the proposals and the timing for the release of the IFRS, AASB staff recommend that the IFRS should:

- only require entities to test their exploration and evaluation assets for impairment when the impairment indicators at ED 6.13(a) – (e) are triggered – with the impairment indicator at ED 6.13(f) deleted;
- delete the CGU-EEA concession; and
- permit entities to recognise and measure exploration and evaluation costs according to 'grandfathered' national GAAP where readily discernible, and in all other cases allow the grandfathering of an entity's existing accounting policies.

The AASB staff comments that follow are primarily directed towards the proposals as outlined in the ED 6.

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).

Guidance on exploration and evaluation

AASB staff believes that the IFRS should clearly delimit when an 'exploration and evaluation' activity concludes by providing additional commentary. This would help ensure that entities choose a consistent point for determining when ED 6 no longer applies and other IFRSs come into effect.

Acquired exploration and evaluation assets

AASB staff believes that the IFRS should provide some guidance on the treatment of acquired exploration and evaluation assets to ensure that they are recognised, measured and tested for impairment in a consistent manner.

Direct and indirect costs

AASB staff note that the exclusion from cost of "administration and other general overhead costs" is consistent with IAS 16.19. However, the AASB believe that the exclusion should not be absolute. That is, administration or other general overhead costs should be able to form part of the cost of an exploration and evaluation asset to the extent that the costs are 'directly attributable' to exploration and evaluation (as per the requirement in IAS 16.16). Much of the administration and overhead cost base for exploration companies can relate directly to field offices and specific exploration programs and current practice has been to treat those directly attributable costs as exploration and evaluation costs.[1] To avoid the potential for differing interpretations emerging, the boundaries of the overheads cost exclusion should be clarified in the IFRS using the notion of directly attributable costs.

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?

Grandfathering existing policies

As noted earlier, AASB staff support the proposal to allow entities to access 'grandfathered' practice for the recognition and measurement of exploration and evaluation costs. However, AASB staff are strongly of the view that all entities that engage in exploration and evaluation activities (i.e. entities that are currently involved in exploration and evaluation and entities that will become involved in exploration and evaluation on or after their first-time application of IFRSs) should be permitted to access the grandfathering.

The grandfathering approach adopted by ED 6 allows entities to elect to use the accounting policies they applied in their most recent annual financial statements. Unlike the grandfathering approach in IFRS 4, ED 6 requires 'new entrants' (i.e. those

1 For example, the field office, because of its remoteness from the corporate office, may contain office equipment and office staff that directly support the exploration activity notwithstanding that those resources are not themselves used in exploration. AASB staff believe these types of costs should be included in the exploration and evaluation asset.

entities that will become involved in exploration and evaluation on or after their first-time application of IFRSs) to apply the IAS 8 hierarchy to develop an accounting policy for exploration and evaluation costs.[2] Consequently, AASB staff note that ED 6's grandfathering proposal is inconsistent with:

- the approach taken in IFRS 4;
- a stated objective of ED 6, being "to make limited improvements to accounting practices for *exploration and evaluation expenditures*, without requiring major changes that may need to be reversed…" (refer ED 6.1(a)); and
- one of the IASB's objectives of having the same transactions treated in the same manner no matter which entity undertakes those transactions – a 'new' entity or a 'grandfathered' entity.

Improvements to accounting policies

AASB staff support the proposals to permit entities to improve their accounting policies for exploration and evaluation costs. Although for completeness, AASB staff suggest that ED 6 also provide guidance on whether an entity can adopt a 'new' accounting policy as permitted under ED 6.11 on first-time adoption.

Revaluing exploration and evaluation assets

ED 6.10 permits the revaluation of exploration and evaluation assets where the requirements of either IAS 38 or IAS 16 are satisfied. Under IAS 38, revaluation is permitted if the asset's fair value can be determined by reference to an active market. In contrast, under IAS 16, exploration and evaluation assets would appear to be able to be revalued if market-based evidence exists or by otherwise estimating fair value using an income or depreciated replacement cost approach. Consequently, a much broader scope for revaluations of exploration and evaluation asset appears to exist under IAS 16.

AASB staff believe that revaluing exploration and evaluation assets should not be permitted as part of the "interim Standard" unless the revaluations form part of an entity's grandfathered accounting policy. AASB staff are concerned with allowing revaluations under IAS 16 for two key reasons:

- vastly different assumptions may be used to determine fair value of an exploration and evaluation asset under, say, an income approach – AASB staff believe revaluing recognised assets which may incorporate reserves/resources should instead be considered as part of the long-term extractive activities project; and
- the flexibility that now exists in the calculation of 'fair value less costs to sell' for impairment purposes (see further discussion under Question 3) may not provide an adequate safety net for the revaluations. That is, if an exploration and evaluation asset was revalued well above cost, a recoverable amount based on 'fair value less costs to sell' (which may include cash inflows from exploiting any reserves/resources that can be attributed to the exploration and evaluation asset) may be able to justify the inflated revalued carrying amount of the exploration and evaluation asset.

2 AASB staff believe that this would involve applying the research and development requirements of IAS 38 *Intangible Assets* and write off exploration and evaluation costs on the basis that they are akin to research costs or alternatively apply the *Framework* and fail the asset recognition criteria.

For this reason and to remain consistent with the 'grandfathering' principle, AASB staff believe that entities should only be permitted to revalue their exploration and evaluation assets to the extent that it forms part of their grandfathered accounting policy. In those cases, which are likely to be isolated, AASB staff recommend that those entities should also be required to disclose the cost of their exploration and evaluation assets to enhance comparability between cost-based and revaluations-based entities.

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?

CGU-EEA concept

As noted earlier, AASB staff do not support the proposals to test exploration and evaluation assets for impairment at the CGU-EEA level. AASB staff consider that the CGU-EEA, as drafted, represents an unprincipled solution to the problem identified at BC17 that assessing exploration and evaluation assets for impairment may negate the effects of the 'grandfathering'. This is because impairment testing at the CGU-EEA level does not necessarily treat two identical exploration activities consistently. Under the CGU-EEA concept, the determinant for whether or not an entity can continue to recognise their exploration and evaluation costs as assets is likely to be dependent on whether the entity has any unrelated cash inflows that are permitted to be included in any impairment testing of the asset. This is illustrated in the following example.

> Entity A and entity B have an equal interest in an unincorporated joint venture arrangement that is solely focused on exploration and evaluation. Entity A also controls a mine site that is in production and generating cash inflows. In contrast, entity B is not involved in any other extractive activities. Entity A and entity B, as joint venturers, are yet to find a mineral deposit and are continuing to assess the prospectivity of their tenement. If, at that time, both entities were required to undertake a recoverable amount assessment of their exploration and evaluation assets relating to the joint venture, entity A's value-in-use calculation could potentially include the cash inflows generated from its other activities whereas entity B's calculation may result in a 100% impairment write-down.

Furthermore, AASB staff note that the potential broad scope of the CGU-EEA allows entities to continue to carry forward exploration and evaluation costs that relate to an abandoned exploration area if there are still sufficient cash inflows being generated elsewhere within the CGU-EEA.

For this reason, AASB staff recommend that the IASB remove the CGU-EEA concept from the IFRS and instead consider one of the following approaches for impairment testing exploration and evaluation assets:

- most preferred[3] – apply less stringent impairment indicators to exploration and evaluation assets and clarify that recoverable amount only needs to be determined following the triggering of an impairment indicator;
- second preference – specifically exempt exploration and evaluation assets from impairment testing under IAS 36 and instead grandfather existing impairment policies for exploration and evaluation assets; or
- third preference – permit entities to determine recoverable amount by reference to an expected monetary value rather than applying the value-in-use criteria in IAS 36. This option overcomes the problems with the value-in-use calculation, which does not permit the inclusion of future cash flows arising from future capital expenditure.

Calculating recoverable amount under ED 6

If the IFRS does not amend the impairment testing requirements, entities that cannot benefit from the CGU-EEA (i.e. entities that are not generating cash inflows from other production activities) may be required to determine recoverable amount by reference to 'fair value less costs to sell' in order to demonstrate that their capitalised exploration and evaluation costs are recoverable. AASB staff recommend that the IFRS should provide guidance on determining the fair value less costs to sell of exploration and evaluation assets, including:

- whether it is appropriate to use the listed share price of a junior explorer to determine the fair value of its exploration and evaluation asset; and
- advising that 'fair value less costs to sell' of an exploration and evaluation asset can be determined by taking into account the market's assessment of the expected net benefits any acquirer would be able to derive from future capital expenditure on the asset even in instances where those costs would be excluded from value-in-use calculations (as per paragraph BC69(c) to IAS 36). Consequently, entities may be able to rely on 'fair value less costs to sell' even though there is no observable market for the exploration and evaluation asset. Notwithstanding that this interpretation of 'fair value less costs to sell' overcomes a potential shortcoming in the application of value-in-use, AASB staff are concerned with this interpretation more generally as it blurs the distinction between value-in-use and fair value.

Particularly in the latter case above, AASB staff hold the view that relying on 'fair value less costs to sell' as the determinant of recoverable amount for an exploration and evaluation asset will impose additional compliance costs on the entity in order to verify such market expectations.

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3 AASB staff consider this option to be the most preferred on the basis that it would limit the effect that the impairment testing requirement has on the grandfathering proposal and, given staff's concerns about timing, it minimises the changes required to the content of ED 6.

Other matters

AASB staff also believe that the IASB should:

- clarify in the IFRS (although strictly outside its scope) whether exploration and evaluation assets should be amortised on an cash-generating unit, CGU-EEA or individual asset basis; and
- reconsider the requirement that a CGU-EEA can be no larger than a segment as, in some cases, the segments identified by an entity may not represent an appropriate cash-generating unit (e.g. the entity may identify a segment for 'exploration and evaluation' or for each mining or oil and gas operation[4]). Furthermore, the IFRS should also clarify whether, if an entity does not identify segment information, whether the whole entity can be a CGU-EEA or whether the entity must identify segments in accordance with IAS 14 *Segment Reporting*.[5]

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?

AASB staff believe that the impairment indicators at ED 6.13(a) – (e) are appropriate for assessing whether an exploration and evaluation asset may be impaired.

However, the impairment indicator at ED 6.13(f) – being, "the entity does not expect the recognised exploration and evaluation assets to be reasonably capable of being recoverable from a successful development of the specific area, or by its sale" – is considered to be too stringent and operates to counter the practical effect of the grandfathering for entities that only have exploration and evaluation activities. For this reason, AASB staff propose that this indicator should be deleted and that the ED 6 should instead either:

- rely on the indicator at IAS 36.12(g) that "evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected"; or
- apply a different indicator that only considers recoverability once the outcome of the exploration and evaluation activities are more certain. For example, the indicator could be "the exploration and evaluation has reached a stage which permits a reasonable assessment of the existence or otherwise of economically

4 An entity may also identify segment information for each mineral. If the entity had only one mine site, AASB staff note that the appropriate level for testing impairment of the exploration and evaluation asset is not at the individual mineral level (as this would require allocating shared costs to each CGU-EEA) but at the mine site level. AASB staff believe that any limitation on the CGU-EEA concept should be flexible enough to deal with situations like this.

5 AASB staff believe that in limiting the size of a CGU-EEA to a segment, care must be taken to avoid discouraging entities from reporting detailed segment information.

recoverable reserves and the entity does not expect to be able to recoup all of the carrying amount of the exploration and evaluation asset through successful development and exploitation of the exploration area or by its sale".

Furthermore, to ensure that the IFRS is applied consistently, AASB staff suggest clarifying whether the impairment testing requirement on first-time adoption requires:

- only checking if any indicators of impairment exist at that time; or
- an assessment of recoverable amount.

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?

AASB staff agree that the disclosures proposed by ED 6 are appropriate.

AASB staff recommend supplementing the ED 6 disclosures with a reconciliation of the opening and closing balances of an entity's exploration and evaluation assets in instances where an entity recognises its exploration and evaluation costs as assets. This additional disclosure requirement would be consistent with other like assets such as property, plant and equipment and intangibles.

Furthermore, if the impairment testing proposal in ED 6 remains in the IFRS, AASB staff also support requiring the disclosure of:

- a description of the CGU-EEA if the entity elects to test for impairment at the CGU-EEA level;[6] and
- the significant assumptions and methodologies adopted in the impairment testing of an exploration and evaluation asset or CGU-EEA.

As assumptions about the recoverability of exploration and evaluation assets may be more subjective than the assumptions used in assessing the recoverability of other types of assets,[7] AASB staff believe that disclosure of assumptions adopted in impairment testing should be *mandated* in the IFRS (rather than *encouraged*, as per IAS 36.132) in order to enhance comparability between entities.

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6 This additional disclosure is recommended because staff interpret ED 6.16(c) as only requiring entities to indicate whether they assess their exploration and evaluation assets for impairment at the asset, cash-generating unit or CGU-EEA level. Staff believe that requiring a description of the CGU-EEA to be disclosed is consistent with the requirement at IAS 36.130(d)(i) to provide a description of the cash-generating unit.

7 Calculating value-in-use, for instance, may require assumptions about future cash flows, future commodity prices, future exchange rates and discount rates. In contrast, IAS 36 only requires some of these assumptions and methodologies to be disclosed when calculating recoverable amount, and only when an impairment loss is recognised or reversed during the period (see IAS 36.130(e), (f) and (g)).

Other comments

AASB staff also suggest that the IFRS clarify:

- that ED 6 should not apply to contractors that are undertaking exploration and evaluation for a mining or oil and gas company – instead, these entities should apply IAS 18 *Revenue*;

- that the requirement in ED 6.6 to measure exploration and evaluation assets at cost only applies to entities that capitalise their exploration and evaluation costs – some may interpret the proposals as requiring entities that choose to expense all their exploration and evaluation costs to have effectively recognised and impaired those costs. If the exploration and evaluation activity subsequently became successful, IAS 36 would require the entity to re-instate those expenses notwithstanding that the entity intended to expense all their exploration and evaluation costs as incurred; and

- the meaning of "unfavourable price" in ED 6.13(e) – entities may argue that an unfavourable price is a price less than original cost rather than a price below the carrying amount of the exploration and evaluation asset.