Additional Online Chapter on Industry-specific IFRS

IFRS 6: Exploration for and Evaluation of Mineral Resources

After studying this chapter you should be able to:

- ☐ discuss the theoretical issues involved in deciding on an appropriate accounting treatment for such resources
- ☐ outline the requirement of IFRS 6
- ☐ demonstrate a critical understanding of likely future developments.

Introduction

For many years there have been two competing schools of thought regarding the accounting treatment of the costs of exploration for natural mineral resources, such as oil and gas, known as the full-cost method and the successful efforts method. By the very nature of the exploration process, a large number of wells or digs are opened, some of which are successful and some of which are not.

In simple terms, under the full-cost method the costs of unsuccessful exploration activities are considered to be part of the cost of the total exploration activities within a particular cost centre. It follows that, provided that usable mineral reserves are discovered somewhere within that cost centre (normally a country or geographical region), the costs of *unsuccessful* digs are regarded as part of the cost of the *successful* discoveries, and are therefore capitalised as part of the cost – i.e. carrying value – of the discovered mineral reserves. Under the successful efforts method, on the other hand, each individual exploratory activity is considered separately. It follows that the cost of each unsuccessful exploratory activity must automatically be written off as expenses not later than the cessation of the activity, and only the costs of actually successful explorations can be included in the 'costs' of the eventually discovered mineral reserves.

Activity

Is the full-cost method of dealing with mineral exploration costs consistent with the IASB Framework?

Activity feedback

The answer is, as so often, debatable. The successful efforts method is clearly more prudent, which may or may not in itself be an advantage. Perhaps more importantly, the question arises as to whether expenditure on an unsuccessful project can possibly meet the definition of an asset. If an activity is unsuccessful, how can it create an expectation of future benefits flowing to the enterprise? But on the other hand, what is meant by *an* activity? If twenty holes in an area are dug, and three find commercially exploitable oil, is this one activity, which was successful in economic terms, or is it 20 activities, of which three were successful?

The mineral exploration industry naturally prefers the full-cost argument, because this is less conservative and tends to lead to higher reported earnings than the successful efforts method, and no accounting regulator has yet been able to outlaw the full-cost approach.

The creation of IFRS 6

The FASB has had a standard for financial accounting and reporting by oil and gas producing companies since 1979, when FAS-19 was amended by FAS-25. At that time, there was a controversy in the USA over the FASB's unsuccessful attempt to exclude full-cost accounting. In 1998, the then IASC established a Steering Committee to carry out initial work on accounting and financial reporting by entities engaged in extractive industries (which is of course a much wider remit than just oil and gas), and in 2000 the Steering Committee published an Issues Paper. However, in 2001, the IASB announced that it would restart the project only when agenda time permitted, and in September 2002 the Board decided that, in view of the 2005 deadline for adoption of IFRSs by listed corporations in the EU, it was not feasible to complete the necessary detailed analysis and due process in time. In January 2004, the Board published ED 6, the exposure draft of IFRS 6, and in April 2004 it approved a project to be undertaken by the national standard-setters in Australia, Canada, Norway and South Africa that will address accounting for extractive industries generally.

As with a number of other standards, therefore (such as IFRSs 3 and 4), IFRS 6 represents a 'first stage' in a two-stage process and is, in effect, a stop-gap standard intended to produce a measure of convergence with US GAAP in time for an effective date of 1 January 2006 as stated in the standard.

Four members of the IASB dissented from the issuance of IFRS 6, on the grounds that the temporary exemption from applying paras 11 and 12 of IAS 8 is inappropriate, especially as there is at present no timetable for a second stage of the process of developing a definitive standard (completion of a comprehensive review of accounting for extractive activities), so that the exemption may be in effect for a considerable time. Two of the dissenters also objected to the modification in IFRS 6 of the impairment recognition requirements of IAS 36. On the other hand, the Board asserted that, with the above exceptions, all IFRSs (including IASs and Interpretations) are applicable to entities engaged in the exploration for and evaluation of mineral resources that make an unreserved statement of compliance with IFRS in accordance with IAS 1 *Presentation of Financial Statements*.

The requirements of IFRS 6

In terms of entities, IFRS 6 is to be applied by all entities that are engaged in the exploration and evaluation of mineral resources. The standard is applicable only to exploration and evaluation expenditures incurred by such entities. It does not address other aspects of accounting by them, and in particular it is not applicable to expenditures incurred:

- *Before* the exploration for and evaluation of mineral resources, such as expenditures incurred before the entity has obtained legal rights to exploration in a given area, i.e. pre-exploration activities.
- *After* the technical feasibility and commercial viability of extracting mineral resources are demonstrable, i.e. development activities.

The reasons for excluding these two areas were:

- The Board did not wish to prejudge the comprehensive review of the accounting for these activities.
- It concluded that an appropriate accounting policy for pre-exploration activities could be developed from an application of existing IFRSs and the IASB *Framework,* while the *Framework* and IAS 38 *Intangible Assets* provide guidance on the recognition of assets arising from development activities.

The Standard gives the following definitions (in Appendix A)

Exploration for and evaluation of mineral resources are defined as the *search* for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources *after the entity has obtained legal rights to explore in a specific area*, as well as the *determination* of the technical feasibility and commercial viability of extracting the mineral resources.

Exploration and evaluation expenditures are defined as expenditures incurred by an entity in connection with the exploration for and evaluation of mineral resources *before the technical feasibility and commercial viability* of extracting a mineral resource are demonstrable.

Exploration and evaluation assets are exploration and evaluation expenditures recognized as assets in accordance with the entity's accounting policy.

An entity recognizing exploration and evaluation assets is required to apply para. 10 of IAS 8 when developing its accounting policies for such assets. It is also required to follow IFRS 6 paras 9 and 10 (see below) in determining which exploration and evaluation expenditures are recognized as assets. However, as a temporary measure it is exempted from the requirement to follow paras 11 and 12 of IAS 8, which specify sources of authoritative guidance that must be considered in developing an accounting policy for an item if no IFRS applies specifically to that item.

IFRS 6 requires an entity to determine a policy specifying which expenditures are recognized as exploration and evaluation assets, and to apply the policy consistently. In doing so, it should consider the degree to which the expenditure *can be associated with finding specific mineral resources*. The following examples are given of types of expenditure that *might* be included in the initial measurement; the list is intended neither to be exhaustive nor to indicate that such expenditures *should* be so included:

- acquisition of rights to explore
- topographical, geological, geochemical and geophysical studies
- exploratory drilling
- trenching
- sampling
- activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource.

Expenditures related to the *development* of mineral resources are not to be recognized as *exploration and evaluation* assets, but should be considered for recognition as *assets arising from development* in the light of guidance from the *Framework* and IAS 38 (IFRS 6 paras 9 and 10).

Activity

From your knowledge of IAS 8, attempt to rationalize the requirements in IFRS 6 relating to IAS 8 paras 10, 11, and 12.

Activity feedback

IAS 8 para. 10 requires management, in the absence of a Standard or Interpretation that specifically applies to a transaction, other event or condition, to use their judgement in developing and applying an accounting policy that results in information that is both relevant and reliable. IAS 8 paras 11 and 12 require management, in making such a judgement, to consider the applicability of the following sources, in hierarchical order:

- first, Standards and Interpretations dealing with similar issues
- second, the definitions, recognition criteria and measurement concepts in the Framework
- third, the most recent pronouncements of other standard-setting bodies using a similar conceptual framework, the accounting literature and industry practices.

The sources to which IAS 8 paras 11 and 12 would point in this case notably include IAS 16 for tangible assets and IAS 38 for intangibles. The Board's problem concerned particularly the latter. The Board considered that the recognition criteria of IAS 38 were more restrictive than those that are commonly used for exploration and evaluation assets, and that application of IAS 38 might result in an overly conservative treatment of exploration and evaluation expenditures, i.e. an overstatement of expenses. Given the absence of internationally accepted standards for such expenditures, the diversity of existing practices, and in particular the unresolved issue of the acceptability of the full-cost method, the Board took the view that until a comprehensive review of accounting for extractive industries had been completed, an entity should be permitted to continue following the accounting policies it was using when it first applied IFRS 6, provided they satisfy the requirements of para. 10 of IAS 8 with regard to recognition as well as paras 9 and 10 of IFRS 6 (the latter being hardly restrictive, except as regards the exclusion of development expenditure). Thus, the Board did not feel ready to take the bull by the horns as regards the inappropriate recognition of assets under the full-cost method.

A distinction is made between measurement at recognition and after recognition. At recognition, exploration and evaluation assets are to be measured at cost (IFRS 6 para. 8).

Any obligations for removal and restoration incurred during a period, as a consequence of mineral resource exploration or evaluation activities, must be recognized in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (IFRS 6 para. 11).

Regarding measurement after recognition, entities are given a choice between the *cost model* and the *revaluation model* as set out in IAS 16 for property, plant and equipment and in IAS 38 for intangible assets. If the revaluation model is used this must be done consistently with the classification of the assets as tangible or intangible (IFRS 6 para. 12).

The revaluation model for tangible assets, and that for intangibles, has somewhat different requirements for the determination of fair value. For intangibles, reference to an *active market* is required, while for property, plant and equipment the requirement is only for *market-based evidence*. The requirement in para. 12 is intended to prevent 'accounting arbitrage' between the two. Any revaluation of exploration and evaluation assets as a result of their being acquired in a business combination should be carried out in accordance with IFRS 3.

A change in accounting policies for exploration and evaluation expenditures is permitted only if it demonstrably makes the financial statements:

- either *more relevant* and *no less reliable*
- or *more reliable* and *no less relevant*

to the economic decision-making needs of users, using the IAS 8 criteria for relevance and reliability. However, the change need not achieve full compliance with those criteria (IFRS 6 paras 13 and 14).

The key issue regarding the presentation of exploration and evaluation assets is one of classification, namely whether the assets are presented as tangible or as intangible. Some are treated as intangible (e.g. drilling rights) while others are clearly tangible (e.g. drilling rigs and vehicles). More formally, exploration and evaluation assets are to be classified as tangible or intangible *according to the nature of the assets acquired*, and the classification shall be applied consistently. Insofar as a tangible asset is consumed in developing an intangible asset, the amount reflecting that consumption (e.g. depreciation) is part of the cost of the intangible; however, this does not turn the tangible asset into an intangible asset (IFRS 6 paras 15 and 16). Clearly, pending completion of the comprehensive review of accounting practices for the extractive industries, the Board did not wish to lay down criteria in IFRS 6 as to which exploration and evaluation assets should be classified as tangible or intangible. It preferred to state that the elements of exploration and evaluation assets should be *classified according to their nature* (this classification being applied consistently).

The main issues that arises in connection with impairment of exploration and evaluation assets concern:

- the facts and circumstances that should trigger an impairment test
- the level of aggregation at which the assets are assessed for impairment.

An exploration and evaluation asset should be assessed for impairment when facts and circumstances suggest that its carrying amount may exceed its recoverable amount. In such a case, any resulting impairment loss shall be measured, presented and disclosed in accordance with IAS 36, except that IAS 36 will not be applied in respect of the following:

- the criteria for identifying the need for an impairment test are those stated in IFRS 6 para. 20
- the level at which the impairment test is to be carried out is specified in IFRS 6 para. 21.

The term 'assets' used in para. 20 applies equally to separate exploration and evaluation assets or to a cash-generating unit (IFRS 6 paras 18 and 19).

One or more of the following indicate the need for an impairment test of exploration and evaluation assets, to be carried out in accordance with IAS 36 subject to para. 21 below, any impairment loss being recognized as an expense as required by IAS 36 (the list is not exhaustive):

- The period for which the entity has the right to explore in a specific area has expired during the reporting period or will expire in the near future, and is not expected to be renewed.
- Substantive expenditure on further exploration for and evaluation of mineral resources in a specific area is neither budgeted nor planned.
- Exploration for and evaluation of mineral resources in a specific area have not led to the discovery of commercially viable quantities of mineral resources and the entity has decided to discontinue such activities in the area.
- Sufficient data exists to indicate that, although a development in the area is likely to proceed, it is unlikely that the carrying amount of the exploration and evaluation asset will be fully recovered from successful development or by sale (IFRS 6 para. 20).

As regards the appropriate level of aggregation for impairment tests, an entity is required to determine an accounting policy for allocating exploration and evaluation assets to cash-generating units or groups of cash-generating units for the purpose of assessing such assets for impairment. No such unit or group of units shall be larger than a segment based on either the entity's primary reporting format or its secondary reporting format determined in accordance with IAS 14 *Segment Reporting*. The level at which impairment testing of exploration and evaluation assets is to be carried may thus comprise one or more cash generating units (IFRS 6 paras 20 and 21).

A problem arises in that exploration and evaluation assets may not generate identifiable cash flows, especially in the case of entities that perform only exploration. In such cases, there is insufficient information about the mineral resources in a specific area for the entity to make reasonable estimates of the assets' recoverable amount, because the activities have not reached a stage at which information to estimate future cash flows is available. Thus, it is not possible to estimate either fair value less costs to sell, or value in use, as required by IAS 36. Application of IAS 36 in such cases would typically lead to an immediate write-off of exploration assets, unlike existing methods of accounting for such assets which the Board did not wish to ban at this time. Hence, the Board decided that IFRS 6 would permit exploration and evaluation assets not to be tested for impairment until the entity had sufficient data to determine technical feasibility and commercial viability. When such information becomes available, or other facts and circumstances (as indicated above) suggest that an exploration and evaluation asset might be impaired, the assets must be assessed for impairment.

In respect of the amounts recognized in its financial statements arising from the exploration for and evaluation of mineral resources, an entity is required to disclose information that identifies and explains them, namely:

- its accounting policies for exploration and evaluation expenditures, including the recognition of exploration and evaluation assets which shall be recognized as a separate class of assets
- the amounts of assets, liabilities, income and expense and operating and investing cash flows rising from the exploration for and evaluation of mineral resources
- the disclosures required by IAS 16 and IAS 38, as applicable, consistently with how the assets are classified as tangible or intangible.

The IFRS is to be applied for annual periods beginning on or after 1 January 2006, earlier application being encouraged, but such earlier application is to be disclosed.

If it is impractical (as defined in IAS 8) to apply a particular requirement of IFRS 6 para. 18 as regards testing for impairment losses to comparative information for annual periods beginning before 1 January 2006, this fact must be disclosed.