IFRS 6, exploration for and evaluation of mineral resources

discovery

The impact of International Financial Reporting Standards (IFRSs) has been felt extensively in the exploration industry – particularly the oil and gas industry where key dilemmas and judgements made are greatest at the exploration and production stage. At one end, IFRS 6, *Exploration for and evaluation of mineral resources* has introduced certain issues for the industry, and, at the other, IFRS is shifting the boundaries of cash-generating units down to the level of the petrol station or smallest group of retailing assets under IAS 36, *Impairment of assets*.

IFRS 6 is an interim standard, and is a short-term solution to the problem of accounting for the exploration and evaluation of mineral resource assets. There was a lack of guidance prior to this IFRS, and where national standards did exist, the accounting practices were diverse, and a number were used throughout the world to account for the costs involved in exploration and extraction. These included capitalising the costs, or writing them off in the same way as research expenses.

Most of the major entities in this sector use the 'successful efforts' method, where the costs incurred in finding, acquiring, and developing reserves are capitalised on a 'field by field' basis. On discovery of a commercially-viable mineral reserve, the capitalised costs are allocated to the discovery. If a discovery is not made, the expenditure is charged as an expense. However, some companies have used the 'full cost' approach, where all costs are capitalised. Without IFRS 6, many entities would have had to change their practice of accounting for these costs. It would have forced them to fall back to the IASB Framework, or to standards issued by their respective national standard setters.

IFRS 6 makes limited changes to existing practice. This means that the fundamental principal of capitalisation of exploration costs, used by the majority of mining entities, still remains. A principal purpose of the IFRS is to specify the circumstances in which entities should test exploration and evaluation costs for impairment, and when to require disclosure of information about such assets.

IFRS 6 permits entities to continue to use their existing accounting policies, provided they comply with paragraph 10 of IAS 8, *Accounting policies, changes in accounting estimates and errors* – that is they result in information which is relevant and reliable. An entity accounts for its exploration and evaluation expenditure either in accordance with the IASB Framework or with the exemption permitted by IFRS 6. This allows an entity to apply an accounting policy for exploration and evaluation assets which is relevant and reliable, even though the policy may not be in full compliance with the IASB Framework. The criteria to be used to determine if a policy is relevant and reliable are set out in paragraph 10 of IAS 8. A policy must:

- be relevant to the decision-making needs of users
- provide a faithful representation
- reflect the economic substance
- be neutral (free from bias), prudent, and complete.

Changes made to an entity's accounting policy for exploration and extraction assets can only be made if the result is closer to the principles of the IASB Framework. The change must result in a policy that is more relevant and no less reliable, or more reliable and no less relevant, than the previous policy.

The costs capitalised under the IFRS might not meet the IASB Framework definition of an asset because, for example, the capitalisation criteria followed might not require the demonstration of probable future economic benefits. IFRS 6 therefore deems these costs to be assets. Exploration and evaluation expenditure might therefore be capitalised earlier than would otherwise be the case under the IASB Framework.

Recognised exploration and evaluation assets should be classified as either tangible or intangible assets under IFRS 6. Assets recognised in respect of licences and surveys should therefore be classified as intangible assets. Subsequent costs incurred during the exploration and evaluation phase should be capitalised in accordance with this same policy. Basically, the entity can retain the accumulated cost as an exploration asset until there is sufficient information to determine whether there will be commercial cash flows or not.

When first recognised in the balance sheet, exploration and evaluation assets are measured using the cost model. Subsequently, entities can measure these assets using the cost or the revaluation model, as described in IAS 16 and IAS 38. Depreciation and amortisation is not calculated for the assets because the economic benefits that the assets represent are not consumed until the production phase.

Assets should be tested for impairment if the book value of the asset may not be recoverable. The facts and circumstances indicating impairment include the following:

- The entity's right to explore in an area has expired, or will expire in the near future, without renewal.
- No further exploration or evaluation is planned or budgeted for.
- A decision has been made to discontinue exploration and evaluation in an area because of the absence of commercial reserves.
- Sufficient data exists to indicate that the book value will not be fully recovered from future development and production.

As this type of asset does not generate cash inflows, it is tested for impairment as part of a larger group of assets. An entity should develop a policy for allocating these assets to groups of cash generating units (CGUs) and apply that policy consistently. The assets are tested for impairment in accordance with IAS 36, subject to certain special requirements. The limitation specified in the IFRS is that the CGU to which the assets are allocated should not be larger than a segment of the entity. IAS 36 specifies that a CGU is the smallest unit for which independent cash flows can be identified. Without this exemption, it could mean that each individual extraction unit (such as an oil rig) would be treated as a CGU. IFRS 6 therefore also gives some flexibility when defining a CGU.

Once the technical and commercial feasibility of extracting a mineral resource has been demonstrated, the assets fall outside IFRS 6 and are reclassified according to other IFRSs. Before reclassification, the assets should be tested for impairment.

Exploration and development costs that are capitalised are classified as non-current assets in the balance sheet, and should be separately disclosed on the face of the balance sheet and distinguished from production assets, where material. The classification as 'tangible' or 'intangible', established during the exploration phase, should be continued through to the development and production phases. Details of the amounts capitalised, and the amounts recognised as an expense from exploration, development, and production activities, should be disclosed.

Conclusion

IFRS 6 allows entities using quite different accounting policies to all claim adherence to the standard, effectively exempting them from applying the IASB Framework. This is similar to IFRS 4, *Insurance Contracts*. It was argued that it was too harsh to force those entities that use capitalisation in their accounts to switch to expensing, even though IAS 38 requires this. It was also argued that some entities are created just to carry out exploration, and once this is complete, they sell the rights to the minerals found. If the IASB Framework or IAS 36 was applied to these entities, then no assets would ever be recognised. The IASB accepted these arguments and therefore issued IFRS 6. ■

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test your understanding

1 **What is an entity required to consider when deciding on its accounting policies for exploration and evaluation activities?**

A The requirements and guidance in IFRSs dealing with similar and related issues
B The definitions, recognition criteria, and measurement concepts set out in the IASB Framework
C Recent pronouncements of standard-setting bodies, and accepted industry practices
D Whether the accounting policy results in information that is relevant and reliable

2 **Is an entity ever required or permitted to change its accounting policy for exploration and evaluation expenditure?**

A Entities are required to change accounting policy for expenditure if the change results in more useful information
B Entities can change accounting policies as long as the new policy results in information that is relevant and reliable
C Only if the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs
D An entity would not be permitted to change accounting policy unless there is a new or revised standard that replaces the existing requirements in IFRS 6

3 **Which of the following facts or circumstances would not trigger a need to test an evaluation and exploration asset for impairment?**

A Lack of sufficient data to determine whether the carrying amount of the exploration and evaluation asset is likely to be recovered in full from successful development or by sale
B The expiration of the period for which the entity has the right to explore in the specific area, unless the right is expected to be renewed
C The absence of budgeted or planned substantive expenditure on further exploration and evaluation activities in the specific area
D A decision to discontinue exploration and evaluation activities in the specific area when those activities have not led to the discovery of commercially-viable quantities of mineral resources

(Answers 1d, 2c, 3a)