IFRS 6 exploration for and evolution of mineral resources - a closer look

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IFRS 6
Exploration for and Evaluation of Mineral Resources - A Closer Look

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In the absence of a global accounting standard dealing specifically with extractive activities (mining and oil and gas), the International Accounting Standards Committee (IASC) published the Issues Paper *Extractive Industries* in November 2000. The International Accounting Standards Board (IASB) carried over the Project on extractive industries from its predecessor organization IASC on 1 April 2001. The IASB, on 16 January 2004, issued Exposure Draft ED 6 *Exploration for and Evaluation of Mineral Resources*. Following comments received on ED 6, IASB on 9 December 2004, issued International Financial Reporting Standard (IFRS) 6 *Exploration for and Evaluation of Mineral Resources*. IFRS 6 is shorter than many recent standards running to a mere 27 paragraphs excluding appendices.

Introducing IFRS 6, Sir David Tweedie, IASB Chairman, said: Developing a widely respected accounting standard that addresses the many complex practical and conceptual problems in the accounting for extractive activities is a concern for the IASB. However, the Board could not consider and reach an informed conclusion on all issues and viewpoints and complete its work by the 2005 deadline for the introduction of IFRSs in many jurisdictions. At the urging of some of our partner national standard-setters and other interested parties, the IASB has developed IFRS 6 to provide some initial guidance on accounting for some extractive activities without imposing significant costs on those industries in advance of completing the larger project. Although the requirements are not mandatory until 2006, entities wishing to adopt IFRS 6 early are encouraged to do so, and the standard contains special transitional provisions for that purpose."

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Objective

The publication of IFRS 6 provides, for the first time, guidance on accounting for exploration and evaluation expenditures, including the recognition of exploration and evaluation assets, and completes the first step in the IASB's project to achieve the convergence of widely varying accounting practices for extractive activities around the world. The objective of IFRS 6 is to specify the financial reporting for the exploration for and evaluation of mineral resources. The principal objective of IFRS 6 is to limit the need for entities to change their existing accounting policies for exploration and evaluation assets.

Scope

IFRS 6 applies to exploration and evaluation expenditures, i.e. to expenditures incurred by an entity in connection with the exploration for and evaluation of mineral resources (including minerals, oil, natural gas and similar non-regenerative resources) before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. Affected activities include the search for mineral resources, as well as the determination of the technical feasibility and commercial viability of extracting those resources.

The following are specifically excluded from the scope of IFRS 6:

• Expenditures incurred before the entity has obtained legal rights to explore in a specific area; and

• Expenditures incurred after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

Definition of Exploration for and Evaluation of Mineral Resources

Exploration for and evaluation of mineral resources is 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 resource.

Requirements

The IFRS 6:

(a) Permits entities to develop an accounting policy for exploration and evaluation assets without specifically considering the requirements of paragraphs 11 and 12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Thus, entities adopting IFRS 6 may continue to use the accounting policies applied immediately before adopting the IFRS provided that such policies result in information that is relevant and reliable. This includes continuing to use recognition and measurement practices that are part of those accounting policies.

(b) Requires entities recognising exploration and evaluation assets to perform an impairment test on those assets when facts and circumstances suggest that the carrying amount of the assets may exceed their recoverable amount.

(c) Varies the recognition of impairment in respect of such assets from that in IAS 36 *Impairment of Assets* but measures the impairment in accordance with IAS 36 once an impairment is identified.

(d) Requires disclosure of information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources, including
(i) its accounting policies for exploration and evaluation expenditures including the recognition of exploration and evaluation assets.
(ii) the amounts of assets, liabilities, income and expense and operating and investing cash flows arising from the exploration for and evaluation of mineral resources.

Accounting policies

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 IFRS 6, 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.
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.

Selection of Accounting Policies

IFRS 6 allows entities using quite different accounting policies to all claim adherences to the standard, effectively exempting them from applying the IASB Framework. This is similar to IFRS 4, *Insurance Contracts*. It was 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.

A wide variety of accounting policies are followed by entities engaged in the exploration for and evaluation of mineral resources – ranging from deferring on the balance sheet nearly all exploration and evaluation expenditures, to recognising all such expenditures in profit or loss as incurred. IFRS 6 does not require or prohibit any specific accounting policies for the recognition and measurement of exploration and evaluation assets. Rather, IFRS 6 permits entities to continue to use their existing accounting policies, provided that they comply with the requirements of paragraph 10 of IAS 8 – i.e. that they result in information that is relevant to the economic decision-making needs of users, and that is 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.

Paragraphs 11 and 12 of IAS 8 specify the various sources of authoritative requirements and guidance that should generally be considered in developing an accounting policy for an item if no IFRS specifically applies. There had been concern that requiring entities to apply those paragraphs when assessing their existing accounting policies for exploration and evaluation assets would highlight areas of uncertainty. To avoid the potential costs and disruption that such uncertainties could cause, IFRS 6 grants a temporary exemption from applying paragraphs 11 and 12 of IAS 8 until the Board addresses these issues as part of a comprehensive project.

Changes in accounting policies

Entities may change their accounting policies for exploration and evaluation expenditures 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, judged using the criteria in IAS 8. 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 adoption of IFRS 6 will not generally result in changes in accounting policies for the recognition and measurement of exploration and evaluation assets. Where an entity voluntarily changes its accounting policies to improve the relevance or reliability of the financial information provided in respect of such assets, then the general principles of IAS 8 apply. Therefore, such changes in accounting policies should be applied retrospectively, unless it is impracticable to do so.

Costs which may be treated as exploration and evaluation costs

Entities must develop a policy for the capitalisation of exploration and evaluation costs and apply it consistently. IFRS 6 lists the following as examples of expenditures that might be included in the initial measurement of exploration and evaluation assets (the list is not exhaustive):
*acquisition of rights to explore; topographical, geological, geochemical and geophysical studies;
*exploratory drilling; trenching; sampling; and activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource.

Assets to be measured at cost at recognition

When they are first recognised in the balance sheet, exploration and evaluation assets are required to be measured at cost. The expenditures to be included in the cost of such assets are determined by the entity as a matter of accounting policy, which should be applied consistently. In making this determination, the entity should consider the degree to which the expenditures can be associated with finding specific mineral resources.

Where an entity incurs obligations for removal and restoration as a consequence of having undertaken the exploration for and evaluation of mineral resources, those obligations are recognised in accordance with the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Subsequent measurement

Unlike the exposure draft, the IFRS 6 does not specifically exclude administration or other general costs where these costs relate directly to the exploration and evaluation activity. When first recognised in the balance sheet, exploration and evaluation assets are measured using the cost model. After original recognition, entities can apply either the cost model or the revaluation model to exploration and evaluation assets. Where the revaluation model is selected, the rules of IAS 16 *Property, Plant and Equipment* are applied to exploration and evaluation assets classified as tangible assets, and the rules of IAS 38 *Intangible Assets* are applied to those classified as intangible assets.
Both these require valuations to be based on fair value by reference to the market and thus reliable valuations may be difficult to determine. In practice, this means it will be rare for assets to be recognised at anything other than cost. There are some restrictions on the capitalisation of costs to the extent that entities can only apply IFRS 6 once they have obtained the legal right to explore a specific area and must stop applying it once technical feasibility and commercial viability have been established. Thus costs incurred before an exploration licence, or similar, has been obtained should be written off to the profit and loss account as incurred. Depreciation and amortisation is not calculated for the assets because the economic benefits that the assets represent are not consumed until the production phase.

Impairment

Where the facts and circumstances indicate that exploration and evaluation costs exceed their recoverable amount they should be tested for impairment. Indications of impairment include the period for which the entity has the right to carry out exploration activities coming to an end, costs going over budget without the additional expenditure being planned, the discontinuance of activities in an area or an indication that the capitalised costs exceed the estimated recoverable amount.

Because of the difficulty in obtaining the information necessary to estimate future cash flows from exploration and evaluation assets, IFRS 6 modifies the rules of IAS 36 as regards the circumstances in which such assets are required to be assessed for impairment. A detailed impairment test is required in two circumstances:

• when the technical feasibility and commercial viability of extracting a mineral resource become demonstrable, at which point the asset falls outside the scope of IFRS 6 and is reclassified in the financial statements; and

• when facts and circumstances suggest that the asset's carrying amount may exceed its recoverable amount.

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 determine an accounting policy for allocating these assets to groups of cash generating units (CGUs) and apply that policy consistently. When such circumstances, or similar circumstances, arise, the entity is required to assess the affected assets for impairment in accordance with IAS 36, subject to special requirements with respect to the level at which impairment is assessed. IFRS 6 allows a greater degree of flexibility as regards the level at which the impairment assessment should be performed. The allocation of exploration and evaluation assets to CGUs, or groups of units, for the purpose of assessing such assets for impairment can be determined as a matter of accounting policy by individual entities. The only limitation specified is that each CGU, or group of units, to which an exploration and evaluation asset is allocated for this purpose should not be larger than an operating segment determined in accordance with IFRS 8 *Operating Segments*.

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.

Exploration and evaluation assets shall be assessed for impairment when facts and circumstances suggest that the carrying amount of an exploration and evaluation asset may exceed its recoverable amount. When facts and circumstances suggest that the carrying amount exceeds the recoverable amount, an entity shall measure, present and disclose any resulting impairment loss in accordance with IAS 36. In considering whether an asset has been impaired entities should group assets by reference to cash generating units and segmental reporting with no aggregated group of assets being larger than a segmental unit (as defined in other IAS). For example if an entity reports its assets by country it could assess impairment on a countrywide basis. However, the IFRS 6 does not preclude the use of a smaller identifiable group of assets.

IFRS 6 includes the following examples of “facts and circumstances” that may indicate that an entity should test exploration and evaluation assets for impairment (the list is not exhaustive):

• 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;

• substantive expenditure on further exploration for and evaluation of mineral resources in the specific area is neither budgeted nor planned;
• exploration for and evaluation of mineral resources in the 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 specific area; and
• sufficient data exist to indicate that, although a development in the specific area is likely to proceed, the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full from successful development or by sale.

Presentation

The nature of a cost should drive how an asset is classified. Recognised exploration and evaluation assets should be classified as either tangible or intangible assets under IFRS 6. Examples of assets to be classified as tangible assets are vehicles and drilling rigs. Intangible assets will include items such as drilling rights. The drilling costs would normally be treated as intangible whereas the cost of plant acquired to carry out the drilling would normally be a tangible asset.
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. However, where a tangible asset is used in carrying out exploration activities it should be depreciated with the depreciation capitalised as part of the intangible exploration cost asset (rather than merely not depreciating the asset).
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.

Disclosure

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.

Where relevant, entities are required to disclose information that identifies and explains the amounts recognised in their financial statements arising from the exploration for and evaluation of mineral resources. To comply with this requirement, the following should be disclosed:
• the entity's accounting policies for exploration and evaluation expenditures, including the recognition of exploration and evaluation assets; and
• the amounts of assets, liabilities, income and expenses and operating and investing cash flows arising from the exploration for and evaluation of mineral resources.

The amount of exploration and evaluation assets will be treated as a separate class of assets for disclosure purposes. The disclosures required by either IAS 16 or IAS 38 should be made, consistent with how the assets are classified.
The IFRS 6 notes that there has been a lack of authoritative international guidance in relation to mineral resource assets and that where national standards do exist accounting practices required by those standards are diverse.
Recognising this, the standard only makes limited changes to existing accounting practice. Consequently the requirements of the IFRS 6 do not change the fundamental principal of capitalisation of exploration costs that has been applied for many years by the majority of mining exploration companies.

Treatment of evaluation and exploration assets on acquisition

The IFRS doesn't give any further guidance on the treatment of exploration and evaluation costs on acquisition other than cross referring to IFRS 3 *Business Combinations*. This requires a lower "standard of proof" than existing UK standards for the allocation of fair values to intangible assets and suggests that, in future, the amount of goodwill on the acquisition of mineral acquisition costs will reduce.

Effective Date and Transition

IFRS 6 is effective for annual periods beginning on or after 1 January 2006, with earlier application encouraged. If an entity applies IFRS 6 for a period beginning before 1 January 2006, transitional relief is available for some comparative disclosures and that fact should be disclosed. For entities that chose to wait until 1 January 2006 to adopt the Standard, IAS 8 requires the entity to disclose that fact and, if estimable, the expected impact in the period of initial application.

First time adoption

IFRS 1 *First-time Adoption of International Financial Reporting Standards* has been amended for entities adopting IFRSs for the first time before 1 January 2006 and choosing to adopt IFRS 6 before 1 January 2006. Such entities need not present the disclosures required by IFRS 6 for comparative periods in their first IFRS financial statements. This exemption is not available for entities adopting IFRSs for the first time on or after 1 January 2006.

Otherwise, the requirements of IFRS 6 should be applied retrospectively by first-time adopters. Note that the exemption as regards recognition of impairment for comparative periods beginning before 1 January 2006 outlined in the previous section does not apply to first-time adopters. Therefore, for example, entities adopting IFRSs for the first time from 1 January 2005, and electing to adopt IFRS 6 before its effective date, should apply the impairment requirements of IFRS 6 retrospectively at the date of transition.

Post-issue Developments in IFRS 6
Amendments to the standards for first-time adopters of IFRSs and for exploration and evaluation expenditures

At its April 2005 meeting, the IASB discussed a proposed technical correction to IFRS 1 to give effect to the intent of the Board to provide relief from restating comparative information (rather than just producing comparative disclosures). After some discussion, the Board concluded that IFRS 1 did not correctly reflect the intention of the Board and that the correction should be made.

IFRS 1 provided an exemption from the requirement to provide comparative disclosures for IFRS 6 to an entity that both (a) adopts IFRSs for the first time before 1 January 2006 and (b) applies IFRS 6 before that date.

Some constituents raised a concern that the wording of the exemption did not properly convey the IASB's intention, which was to exempt such entities from the requirement to provide comparative information for IFRS 6 in the first year of application.

Given the concern, the IASB decided to amend IFRS 1 and the Basis for Conclusions on IFRS 6 to clarify that such entities are not only exempt from providing comparative disclosures, but also exempt from the recognition and measurement requirements of IFRS 6 for the comparative period.

On 2 May 2005, the IASB invited comments on a proposed small amendment to IFRS 6 and, as a consequence, an amendment to IFRS 1.

On 30 June 2005 the IASB issued amendments to IFRS 1 and the Basis for Conclusions on IFRS 6 to clarify that an entity that both (a) adopts IFRSs for the first time before 1 January 2006 and (b) applies IFRS 6 before that date is exempted not only from providing comparative prior-period disclosures but also from applying the recognition and measurement requirements of IFRS 6 in the prior comparative period. The amendments clarify the IASB's intentions with respect to an exemption provided to first-time adopters of IFRSs who choose to adopt IFRS 6 before 1 January 2006.

Conclusion

The impact of IFRS has been felt extensively in the exploration industry. IFRS 6 is shifting the boundaries of CGUs down to the level of the petrol station or smallest group of retailing assets under IAS 36. IFRS 6 completes only the initial phase of the IASB's project on extractive activities. It seeks to increase transparency by requiring improved disclosures for exploration and evaluation assets.

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