IFRS ACCOUNTING STANDARDS IN PRACTICE

An overview of IFRS 6 *Exploration for and Evaluation of Mineral Resources*

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Introduction

This issue of IFRS® Accounting Standards in Practice summarises the requirements of IFRS 6 *Exploration for and Evaluation of Mineral Resources*, and looks at a number of practical issues which often arise in practice.

Key aspects of IFRS 6 are that it:

- Applies only to Exploration and Evaluation (E&E) expenditure
- Contains an exemption from certain of the requirements of IFRS Accounting Standards, meaning that there are fewer restrictions placed on what qualifies to be capitalised as an asset (or part of an asset)
- Permits a choice of whether an entity expenses all E&E expenditure as incurred, or capitalises that expenditure (in which case there is a choice about how much of that expenditure might be capitalised)
- Contains certain exemptions from the requirements of IAS 36 *Impairment of Assets*, for the purposes of assessing whether E&E expenditure which has been capitalised is impaired.

Current Status of IFRS 6

When IFRS 6 was published in 2004, it was viewed as a 'temporary' standard put in place while the International Accounting Standards Board (IASB) pursued research into developing a consistent set of requirements. However, in September 2021, the IASB made the decision to explore:

- Developing requirements or guidance to improve the disclosure objectives and requirements in IFRS 6 *Exploration for and Evaluation of Mineral Resources* relating to a company's exploration and evaluation expenditure and activities; and
- Removing the temporary status of IFRS 6.

Between 2018-2023, the IASB gathered evidence to help it decide whether to amend or replace IFRS 6 or consider making changes to improve other IFRS Accounting Standards applying to extractive activities.

The IASB decided it lacked sufficient evidence to suggest that the benefits of reduced diversity in the accounting policies applied to exploration and evaluation expenditure would outweigh the costs of implementing any changes. Therefore, the IASB decided not to make any changes.

The IASB decided not to explore developing:

- new or amended recognition and measurement requirements for exploration and evaluation expenditure;
- new or amended disclosure requirements for exploration and evaluation expenditure and activities;
- requirements for the disclosure of reserve and resource information; or
- new or amended requirements for matters outside the scope of IFRS 6 relating to extractive activities.

Following the completion of its comprehensive review of the accounting for extraction activities, the IASB decide to remove the word 'temporary' from the heading of the section in IFRS 6 that exempts an entity from applying some of the requirements in IAS 8 to its accounting policies for exploration and evaluation expenditure. This amendment to IFRS 6 is expected to take place as part of the next volume of Annual Improvements to IFRS Accounting Standards.

Scope

The scope of IFRS 6 *Exploration for and Evaluation of Mineral Resources* is limited to the recognition, measurement and disclosure of expenditure incurred in the phase covering the E&E of mineral resources. Although the term used is 'mineral resources', the definitions in IFRS 6 clarify that this extends to cover minerals, oil, natural gas and other similar non-regenerative resources meaning that it applies across the extractives industry sector.

The limitation of scope to cover the exploration and evaluation phase means that IFRS 6 does not apply to expenditure incurred:

- In the previous prospecting phase
- In all phases after the E&E phase has been completed, including development, production, closure and rehabilitation.

This was confirmed by the IFRS Interpretations Committee (the Committee) at its meeting in January 2006. The Committee considered that IFRS 6 is clear in restricting its scope of IFRS 6 to expenditure incurred in respect of E&E activities, and that there is no basis for interpreting IFRS 6 to provide any relief to areas outside its scope. Consequently, all of the requirements of IFRS Accounting Standards apply to expenditure on other (non E&E) phases.

However, there are some aspects of activities in the extractives industry which, even though they are outside the scope of IFRS 6, are excluded from the scope of specific IFRS Accounting Standards. These include:

- IAS 2 *Inventories*: does not apply to the measurement of inventories held by producers of minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practice in those industries
- IAS 16 *Property, Plant and Equipment*: does not apply to the recognition and measurement of exploration and evaluation assets. However, IAS 16 does apply to equipment which is used by entities in the extractives industry, regardless of the phase (for example, E&E or development)
- IFRS 16 *Leases*: does not apply to leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources. However, like IAS 16, IFRS 16 does apply to leases of assets used by entities in the extractives industry, including those used in E&E activities.
- IAS 38 *Intangible Assets*: does not apply to expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources
- IAS 40 *Investment Property*: does not apply to mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

Consequently, care is needed when determining precisely which expenditure falls within the scope of specific IFRS Accounting Standards. However, for those transactions which fall outside the scope of the IFRS Accounting Standards noted above, it would not be possible to apply IFRS 6 by analogy in order to capitalise certain expenditure that other IFRS Accounting Standards would not permit to be capitalised. This is because the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, under which an IFRS Accounting Standards might be applied by analogy, requires consideration of all of the criteria in IAS 8. As noted below in the section 'Recognition of E&E expenditure', IFRS 6 contains a specific exemption from certain of the requirements of IAS 8 which result in certain items of expenditure being eligible to be capitalised even though they do not meet the definition of an asset in the Conceptual Framework.

BDO comment - Leases to explore for Non-regenerative Resources (e.g. minerals, oil, etc.)

As noted above, IFRS 16 excludes from its scope 'leases to explore for or use mineral, oil, natural gas and similar non-regenerative resources'. Interpreting precisely how this scope exclusion should be applied may be challenging in practice. For example:

1. Does the exemption only apply to projects still in the scope of IFRS 6?
2. Does the exemption apply to 'surface rights' (i.e. amounts paid to private owners of land to access the surface of the land that contains non-regenerative resources) in addition to amounts paid to government authorities to obtain the right to explore for those non-regenerative resources?
3. Does the exemption apply to leases for equipment necessary for the exploration and/or extraction process?
4. Does the exemption apply to leases to access land necessary for the extraction of resources (e.g. a lease of land to place equipment necessary in the extraction process or to place roads needed to access sites)?

Regarding *issue #1*, as the scope exclusion applies to '…leases to explore…', it is unclear whether the scope exclusion is limited to only those projects that are within the scope of IFRS 6. As IFRS 6 is not explicitly noted in IFRS 16's scope exclusion, it would appear that the scope exclusion applies in a more broad sense than only projects still within the scope of IFRS 6 (i.e. projects still in the exploration and evaluation phase of their development).

Item #2 above appears to satisfy the scope exclusion in both cases as they relate to a right to explore land for non-regenerative resources.

For *item #3*, while this relates to a project for the exploration of non-regenerative resources, the rights relate to items necessary to explore for the resources, not the right to explore directly. Leases of equipment do not fall within the scope exclusion in IFRS 16 (i.e. they are not excluded from the requirements of the standard).

For *item #4*, it is necessary to understand which portion of land is being leased. For example, a lease of land which contains an oil field, where the lessee is granted permission to access the land for the purposes of oil exploration and/or extraction would fall within the scope exclusion in IFRS 16. However, leases of other areas of land would be within the scope of IFRS 16. For example, in addition to entering into the lease above over land which contains an oil field, the lessee might also enter into leases of adjacent land (for example, to place pipes for the transporting of oil away from the extraction area). These leases would fall within the scope of IFRS 16 (the scope exclusion would not apply).

It may be complex to determine the point in which the lease of land ceases to be within the scope exclusion to IFRS 16. In our view, a principle that may be applied is that the scope exclusion ceases when significant inputs and processing are no longer being applied to the applicable natural resource. For example, an oil field may be placed on leased property, where the land lease would be excluded from the scope of IFRS 16. The entity would also have to place an oil battery on land that is also leased, immediately adjacent to the oil field. An oil battery is a group of tanks that receive crude oil, where the volume is measured and tested for being pumped into a pipeline system for transport. Cleaning and treating of the oil also typically occur in the battery. In our view, the scope exclusion would apply to the land lease where the battery is placed, since at that point, the land lease still relates to 'leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources'. Once the oil passes beyond the battery into pipelines for transportation, the scope exclusion would cease, as the land over which the pipelines are placed do not relate to 'exploration'. The entity would apply the criteria for determining whether the land on which pipelines are placed meet the definition of a lease since the scope exclusion from IFRS 16 would not apply.

Determining the boundary of the scope exclusion will depend on the precise facts and circumstances, and this analysis would not apply in all cases. For example, the conclusion may differ if the oil battery were placed at a significant distance from the oil field from which the oil is extracted.

Frequently asked questions

Question 1

Do pre licence costs fall within the scope of E&E expenditure?

Answer

IFRS 6 states specifically that it does not apply to expenditure incurred before the exploration and evaluation of mineral resources, such as expenditure incurred before the entity has acquired the legal rights to explore a specific area.

Pre licence costs arise before legal title has been obtained over a particular property. Consequently IFRS 6 does not apply, and the requirements of IAS 38 are applied instead.

Question 2

Can costs directly related to acquiring the legal title, that permits exploration and evaluation activities to be carried out, be capitalised?

Answer

Yes, if the entity has an accounting policy to capitalise E&E expenditure (see below). This is because these costs relate to the acquisition of legal title and are therefore linked to an item which falls within the scope of IFRS 6 and qualifies to be capitalised.

Question 3

Can the cost of an option to acquire the legal right to explore a specific area be capitalised in accordance with IFRS 6?

If not, does the cost qualify to be capitalised under another IFRS Accounting Standard?

Answer

It depends. IFRS 6 states specifically that it does not apply to expenditure incurred before the exploration for an evaluation of mineral resources, such as expenditure incurred before the entity has acquired the legal rights to explore a specific area.

Consequently, the acquisition of an option to acquire legal title does not, in itself, fall within the scope of IFRS 6. However, in some cases the terms of an option to acquire legal title permit the entity that has acquired the option to carry out E&E activities on the identified area. In those cases, the acquisition cost of the option can be capitalised within an E&E asset.

If an option to acquire legal title does not permit the entity that has acquired the option to carry out E&E activities on the identified area, assuming that the option is acquired at its fair value, in our view the acquisition cost does still qualify to be capitalised. This is because the option meets the IFRS Accounting Standards definition of an asset. However, questions may arise about which IFRS Accounting Standards applies to the subsequent measurement of the option; depending on the precise terms and conditions, and the holder's past practice and future intentions, the initial carrying amount of the option may simply be subject to impairment tests in accordance with IAS 36 or alternatively it may be within the scope of IFRS 9 *Financial Instruments*. If the option is subsequently exercised, its carrying amount at that point will be included in the initial carrying amount of the acquired legal right to explore.

Recognition of E&E expenditure

IFRS 6 *Exploration for and Evaluation of Mineral Resources* includes an exemption, when determining accounting policies for E&E expenditure, from certain of the requirements of IAS 8. These requirements are set out in IAS 8.11 and 12.

The effect of the exemption is to permit a greater range of expenditure to qualify to be capitalised as an asset in comparison with the approach that would normally be followed under all of the requirements of IFRS Accounting Standards. The IASB noted that existing practice in the extractives industry varied substantially, ranging from deferral of virtually all E&E expenditure on balance sheet to expensing all E&E expenditure as incurred. In order to bring some limited improvements to accounting, while at the same time minimising disruption to those entities that would adopt IFRS 6, the exemption from parts of IAS 8 was granted.

In consequence, IFRS 6 permits entities to develop accounting policies for E&E expenditure that do not meet all of the definitions, recognition criteria and measurement concepts for assets, liabilities income and expenditure in IFRS Accounting Standards. In practice, this results in:

- E&E expenditure being capitalised, where that E&E expenditure would otherwise be likely to be regarded as research expenditure which IAS 38 *Intangible Assets* requires to be expensed as incurred
- Either no recognition at all, or delayed recognition, of impairment of E&E assets in comparison with impairment that would be recognised under the normal requirements of IFRS Accounting Standards. This is because E&E assets are only assessed for impairment when facts and circumstances suggest that the carrying amount of capitalised E&E expenditure exceeds its recoverable amount, and on the transfer from E&E
  to development assets. Before these points, there is no requirement to assess whether impairment exists at the end of each reporting period
- Specific approaches for 'farm in' transactions (see below for a discussion of these transactions), in which a portion or proportion of the risks and rewards associated with a property are transferred to another party in return for a funding commitment. The funding commitment may be in the form of an upfront payment, or be a commitment directly to undertake E&E activity, reimburse a specific amount of future E&E expenditure, or to share in a specified percentage of future expenditure.

In practice, some entities may develop accounting policies for the recognition of assets during the E&E phase that take into account the requirement to apply the more restrictive requirements of IFRS Accounting Standards in full once the development stage is reached.

Accounting policy choice – capitalise or expense E&E expenditure?

After determining which types of expenditure meet the definition of E&E expenditure, an entity has a choice of either capitalising or expensing each of these types of expenditure during the E&E phase. This is an accounting policy choice, to be applied consistently. Consequently, there is a choice of capitalising no E&E expenditure, only some E&E expenditure, or almost all E&E expenditure.

IFRS 6 *Exploration for and Evaluation of Mineral Resources* identifies a number of different types of expenditure that might be considered for capitalisation:

- 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.

BDO comment

The range of types of expenditure that are permitted to be capitalised as E&E assets are broad, including items such as depreciation of property, plant and equipment, and consumables, with (depending on the unit of account used for an E&E area) even costs of failed test results being eligible to be capitalised.

Frequently asked questions

Question 4

An entity is in the process of carrying out E&E activities in a geographic area that it regards as an overall single exploration area. It has an accounting policy of capitalising E&E expenditure. Costs are incurred on a test drilling a well that ultimately proves to be a 'dry well'. Are these costs eligible to be capitalised into the entity's E&E asset?

Answer

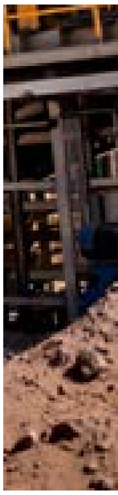
Yes. Because the entity regards the exploration area as a single asset, and does not split it into a number of separate components, the cost of the dry well can be capitalised as it has added to the entity's knowledge of the area of interest as a whole.

Question 5

Where expenditure is similar in nature, but has different probabilities of leading to a successful project, do the different probabilities mean that there is more than one type of expenditure? For example, exploratory drilling activities in different countries or areas may have different assessments of the probability of success. Does that mean that these exploratory drilling activities should be split into components that reflect the probability of success in each country or area?

Answer

The fact that the same type of activity has different probabilities of success does not mean that the expenditure needs to be divided into components. In this example, exploratory drilling activities would be regarded as a single type of expenditure (or unit of account), regardless of whether drilling in one country or area had a higher assessment of success than drilling in another country or area.



Question 6

Are finance costs either permitted or required to be capitalised?

Answer

IAS 23 *Borrowing Costs* requires the capitalisation of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. IAS 23.9 also notes that borrowing costs are capitalised as part of the cost of the related asset when it is probable that they will result in the entity obtaining future economic benefits.

The interaction of the requirements of IAS 23 and IFRS 6 is not entirely clear. This is because the nature of E&E expenditure means that it is unlikely that an entity will be able to satisfy the probability test for future economic benefits. Consequently, it could be argued that capitalising borrowing costs related to E&E assets is not permitted. However, while an approach of not capitalising borrowing costs is our preferred view, it can also be argued that IAS 23 does not override the exception in IFRS 6 from some of the requirements of IAS 8, meaning that it would be consistent with that exception to capitalise borrowing costs.

Consequently, in our view an entity has an accounting policy choice, to be applied consistently, about whether it capitalises borrowing costs associated with E&E activities. If an accounting policy of capitalising borrowing costs is adopted, care will be required to ensure that the accounting treatment of borrowing costs is consistent with whether an entity chooses to capitalise or expense certain types of expenditure in accordance with IFRS 6 (see above).

Question 7

Are administrative and other general overhead costs eligible for capitalisation as part of an E&E asset?

Answer

IFRS 6 does not specify whether administrative and other general overhead costs are eligible for capitalisation as part of an E&E asset. IFRS 6.BC28 notes that, during the development of the standard, an inconsistency was identified between IAS 2 *Inventories paragraph* 11 and IAS 38 *Intangible Assets* paragraph 67 which require directly attributable costs to be capitalised, and IAS 16 *Property, Plant and Equipment* paragraph 19 which prohibits the capitalisation of administrative and other general overhead costs.

Consequently the question of whether administrative and other general overheads are capitalised as part of the cost of an E&E asset is an accounting policy choice, to be applied consistently. It would be appropriate for the accounting policy to be based, by analogy, on either the requirements of IAS 2 and IAS 38, or the requirements of IAS 16; this approach is consistent with the hierarchy of guidance to be followed when a particular IFRS Accounting Standard does not cover a specific issue (see IAS 8.10-12).

Question 8

Entities that undertake E&E activities often incur related obligations for site restoration or asset decommissioning costs. IFRS 6.11 notes that provisions are recognised for those obligations in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. How should the debit entries that arise from these liabilities be accounted for?

Answer

The general approach followed for an obligation for site restoration costs or asset decommissioning costs that arises on the initial recognition of an asset, is for the debit entry to be added to the cost of the asset. Subsequent changes to the estimate of the obligation are added to or deducted from the cost of the related asset. Both of these elements are depreciated or amortised prospectively over the remaining useful life of the asset.

However, for E&E assets the approach followed should link to the accounting policy adopted for, and accounting treatment of, the E&E expenditure itself. To the extent that the E&E expenditure that gives rise to the obligation is capitalised, the debit entry relating to the provision should similarly be capitalised. However, if the E&E expenditure is expensed as incurred, then so too should the cost associated with the provision.

- Obligations relating to site restoration costs or asset decommissioning costs may be long term and, consequently, be recorded at discounted amounts. Any change in the carrying amount of the related provision should always be recognised immediately in profit or loss.

Question 9

If an entity chooses an accounting policy to capitalise E&E expenditure, what approaches are acceptable?

Answer

A number of different methods of capitalising E&E expenditure have historically been used by entities in the extractives sector, in particular ‘successful efforts’, ‘area-of-interest’ and ‘full cost accounting’. A partial capitalisation approach is also commonly followed in practice.

a) *Successful efforts*

Under this approach, in general only those costs that lead directly to the discovery, acquisition, or development of specific, discrete mineral reserves are capitalised. Costs that are known, when they are incurred, to fail to meet this criterion are generally charged to profit or loss as incurred. However, some interpretations of the successful efforts method would result in capitalising the cost of unsuccessful development wells. This might be where an entity views a specified area as being a single cost centre (this may be smaller than an area-of-Interest – see below).

b) *Area-of-Interest*

An area of interest is an individual geological area which is considered to constitute a favourable environment for the presence of a mineral deposit or an oil or natural gas field. Under this approach, all E&E expenditure relating to an area of interest are grouped and capitalised, to the extent that the costs are expected to be recouped either through the successful development and exploitation of the area, or by its sale.

c) *Full cost*

The full cost method generally results in capitalising all costs incurred in prospecting, acquiring mineral interests, exploration, appraisal, development and construction which are then accumulated in large cost centres. There are certain aspects of full cost accounting that are not consistent with the requirements of IFRS Accounting Standards. This includes capitalising all pre licence acquisition costs (which are not within the scope of IFRS 6, as these do not form E&E activities), the need to classify E&E assets as tangible or intangible which is often not carried out for large asset pools, and the need to test E&E assets for impairment at the point at which E&E activity ceases and the assets are reclassified under IAS 16 or IAS 38 (which is typically not possible, as full cost accounting does not disaggregate cost pools in the required level of detail).

d) *Partial capitalisation*

Under this approach, only some costs that are eligible for capitalisation are included in an entity's E&E asset. In some jurisdictions, a common approach is to capitalise initial acquisition costs for a particular mining asset and to expense all subsequent costs.

BDO comment

For those entities in jurisdictions that transition to IFRS, IFRS 6 permits the continued application of many pre-IFRS Accounting Standards accounting policies in respect of E&E expenditure, and permits a variety of approaches to the extent to which future E&E expenditure is capitalised. Similarly, an entity commencing E&E activities that is established in a jurisdiction that has already adopted IFRS Accounting Standards has a choice of capitalising or expensing each type of E&E expenditure.

Consequently there is little consistency globally in respect of the accounting for E&E expenditure, with accounting policies being developed largely along previous GAAP / historic practice lines. However, larger entities, or those entities that operate in jurisdictions more influenced by US GAAP, have often followed the 'successful efforts' method rather than 'full cost'.

As noted above, certain elements of full cost accounting are not consistent with the requirements of IFRS Accounting Standards meaning that, while an entity might use full cost as a starting point for the development of its accounting policy, a number of modifications will be required.

Changes in accounting policy

IFRS 6 *Exploration for and Evaluation of Mineral Resources* includes guidance for changes in the accounting policy applied to E&E expenditure. A change in an entity's accounting policy for E&E expenditure is permitted if this change makes the financial statements 'more relevant to the decision making needs of users and no less reliable, or more reliable and no less relevant' and brings the financial statements 'closer to meeting the criteria in IAS 8'. The reference to IAS 8 is relevant because IFRS 6 grants a temporary exemption from certain requirements of IAS 8, including a requirement to consider the definition of an asset in the Conceptual Framework.

This implies that a change in policy from capitalising all eligible E&E expenditure to successful efforts would be acceptable, as would a change from capitalising E&E expenditure to expensing all expenditure as incurred. This is because it is normally difficult to demonstrate that the costs result in an item that meets the definition of an asset.

Frequently asked questions

Question 10

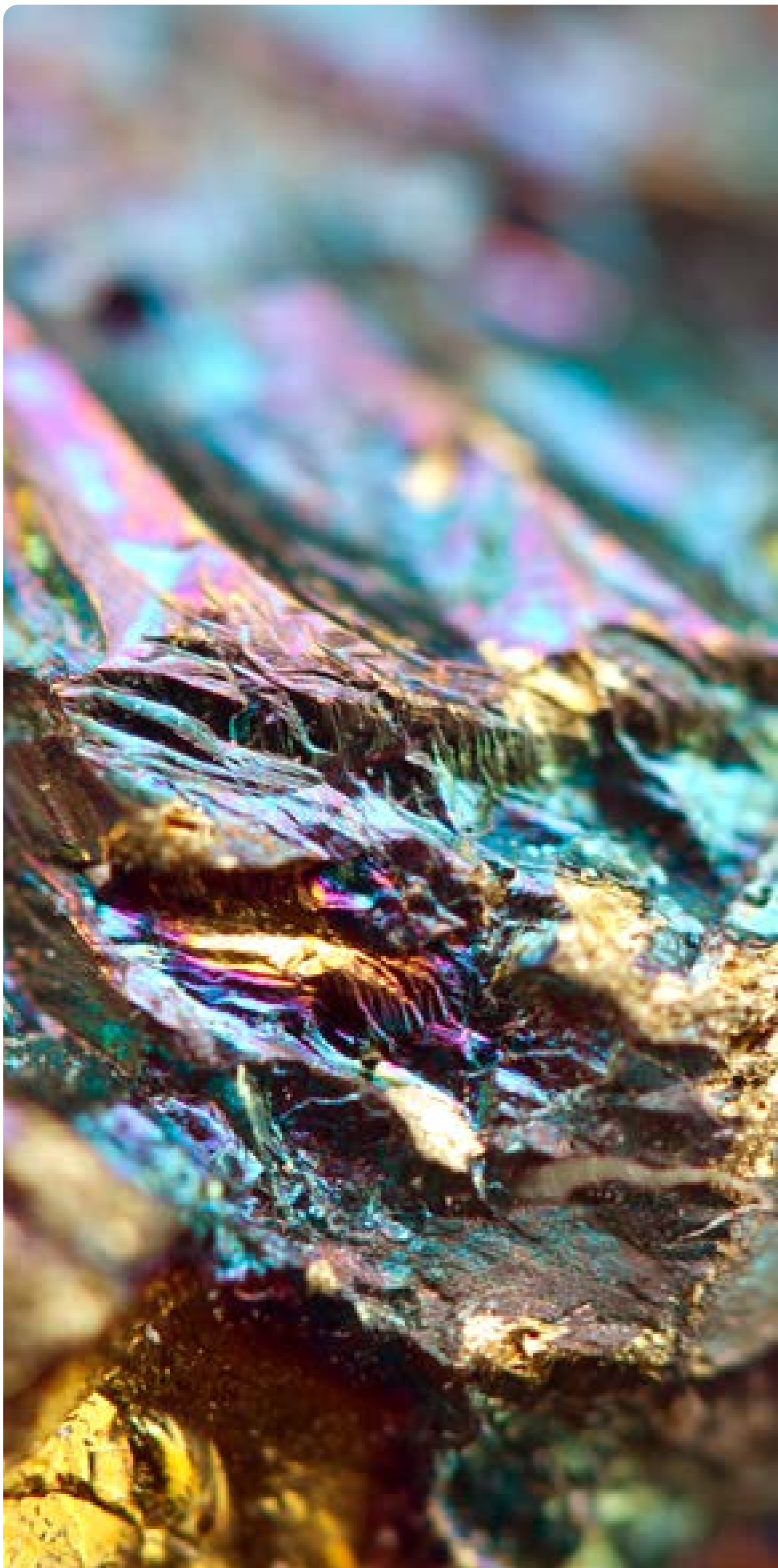
Can an entity change its accounting policy from expensing E&E expenditure to capitalising?

Answer

It would appear difficult to justify moving from an accounting policy of expensing all E&E expenditure as incurred to one of capitalising, as this would appear to result in accounting that is further away from the requirements of the Framework. However, it would be necessary to consider all relevant facts and circumstances.

A change to capitalising E&E expenditure from a successful efforts basis to capitalising all eligible E&E expenditure might be more justifiable, which could be the case if an entity moved from capitalising one type of expenditure to two types (for example, adding topological study costs to other costs that are capitalised). Again, all relevant facts and circumstances need to be considered.

The exemption in IFRS 6 is designed to permit items to be capitalised even though they do not meet the IFRS Accounting Standards definition of an asset. Consequently, if expenditure is incurred on an item that does meet the definition of an asset, then that item can be capitalised.



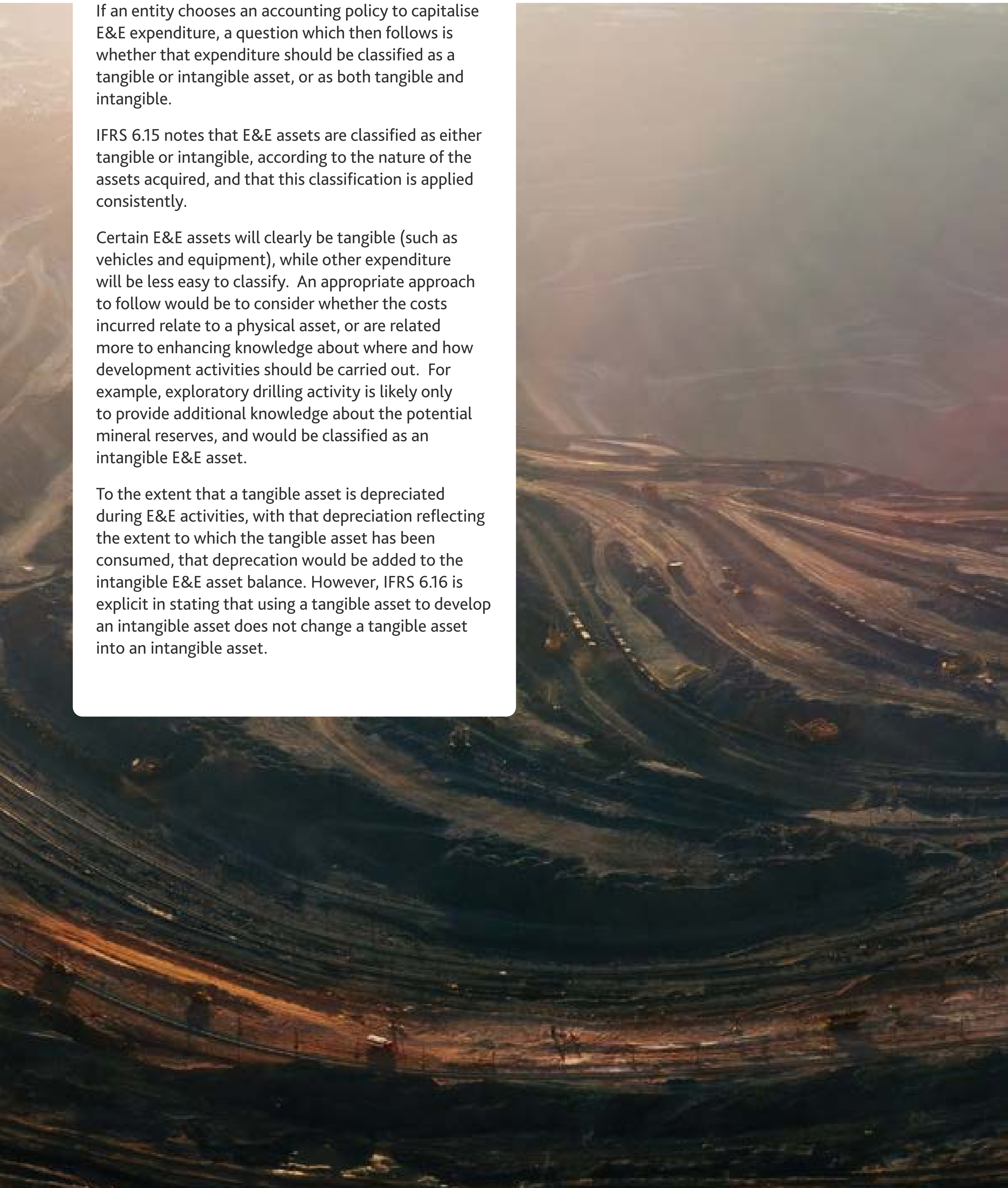
Classification of E&E expenditure

If an entity chooses an accounting policy to capitalise E&E expenditure, a question which then follows is whether that expenditure should be classified as a tangible or intangible asset, or as both tangible and intangible.

IFRS 6.15 notes that E&E assets are classified as either tangible or intangible, according to the nature of the assets acquired, and that this classification is applied consistently.

Certain E&E assets will clearly be tangible (such as vehicles and equipment), while other expenditure will be less easy to classify. An appropriate approach to follow would be to consider whether the costs incurred relate to a physical asset, or are related more to enhancing knowledge about where and how development activities should be carried out. For example, exploratory drilling activity is likely only to provide additional knowledge about the potential mineral reserves, and would be classified as an intangible E&E asset.

To the extent that a tangible asset is depreciated during E&E activities, with that depreciation reflecting the extent to which the tangible asset has been consumed, that deprecation would be added to the intangible E&E asset balance. However, IFRS 6.16 is explicit in stating that using a tangible asset to develop an intangible asset does not change a tangible asset into an intangible asset.



Classification of cash flows

The classification of cash flows relating to E&E activities depends on whether the expenditure is capitalised as an E&E asset. To the extent that it is capitalised, the cash flows are classified as relating to investing activities as they have resulted in a recognised asset (IAS 7 *Statement of Cash Flows* paragraph 16). To the extent that the expenditure is expensed as incurred, the cash flows are classified as relating to operating activities.

Measurement of E&E expenditure

If an entity chooses an accounting policy of capitalising E&E expenditure, this will be recorded at cost on initial recognition. For subsequent measurement there is a choice between the cost model and the revaluation model for an entity's tangible and intangible E&E assets.

The cost model

Under the cost model, tangible assets used for E&E activities (such as vehicles and equipment) will be depreciated to their residual value over their useful economic lives. During the E&E phase, to the extent that these depreciation charges relate to the use of the assets for E&E activities, the charges are added to the cost of the intangible E&E asset itself.

Depreciation or amortisation of each tangible and intangible asset commences when the asset is ready for use. IAS 16.55 and IAS 38.97 both note that this is when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management. For items such as vehicles and equipment, this will normally be straightforward (although it should be noted that depreciation will still be recorded, even if E&E activities are suspended for a period).

The revaluation model

Under the revaluation model, the approach followed is consistent with the guidance set out in IAS 16 for tangible assets and IAS 38 for intangible assets. IFRS 6.25 notes that E&E assets are regarded as being a separate class of assets for the purposes of revaluation. An entity may have E&E assets classified as both tangible and intangible, and each of these can be considered separately for revaluation (that is, an entity could choose to apply the revaluation model to its tangible E&E assets and the cost model to its intangible E&E assets).

IAS 38 permits the revaluation model to be applied to intangible assets only where there is an active market for the related intangible asset. An active market exists only where all of the following conditions apply:

a) The items traded within the market are homogeneous

b) Willing buyers and sellers can normally be found at any time

c) Prices are available to the public.

It is unlikely that these conditions will apply to intangible E&E assets.

Due to their often specialised nature, it will often be difficult to determine the fair value of tangible E&E assets. Consequently, in practice most entities use the cost model.

In addition, because an E&E asset will ultimately be consumed in production or sold, even if an asset was eligible to be revalued it is unlikely that this policy would be adopted. This is because it would result in reduced (possibly significantly reduced, or even nil) profits during the production phase.

Impairment

E&E assets are required to be assessed for impairment (IFRS 6.18), with an impairment test being required when facts and circumstances suggest that the carrying amount of capitalised E&E expenditure exceeds its recoverable amount. However, the impairment requirements contained in IFRS 6 differ from, and are considerably less strict, than the requirements of IAS 36.8-17. In particular, IFRS 6.20 sets out specific circumstances in which E&E assets are required to be tested for possible impairment.

These reliefs from the full requirements of IAS 36 are significant, and mean that the determination of whether a project is in its E&E phase, or has reached the development or preproduction phase, is very important.

IFRS 6.21-22 set out guidance for the allocation of E&E assets to cash generating units (CGUs) or groups of CGUs for the purpose of impairment testing. Care is required when determining an entity's CGUs and in the allocation of E&E assets to those CGUs (see below).

Triggers for an impairment test

When identifying whether an E&E asset is required to be tested for impairment, IFRS 6.20 sets out the following indicators, while also noting that this is not an exhaustive list:

a) 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

b) Substantive expenditure on further Exploration for and Evaluation of Mineral Resources in the specific area is neither budgeted nor planned

c) Exploration for and Evaluation of Mineral Resources in the specific areas 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

d) Sufficient data exists 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 sale.

If any of the above conditions, or other similar conditions, exists then the E&E asset is required to be tested for impairment in accordance with IAS 36. Other conditions that give rise to an impairment test may include significant adverse changes in commodity prices, and changes in tax or regulatory requirements.

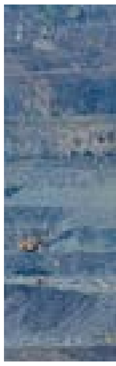
In its original exposure draft (the ED), the IASB proposed that IAS 36 should be applied in full, including the criteria for a trigger event for an impairment test. However, respondents to the ED noted that in some cases, and in particular for exploration only entities, E&E assets do not generate cash flows and there is insufficient information about the mineral resources in a specific area to make reasonable estimates of E&E assets' recoverable amounts. This is because information sufficient to estimate future cash flows would typically not be available, meaning that it would not be possible to estimate the two measures of recoverable amount in IAS 36 (fair value less costs to sell, or value in use). Consequently, the application of the requirements for trigger events that give rise to an impairment test in IAS 36 would result in an immediate write off of E&E assets in many cases. In order to address this point, the IASB concluded that an impairment test of E&E assets should be triggered by changes in facts and circumstances.

The level at which impairment is assessed

IFRS 6 permits the aggregation of CGUs for the purposes of impairment tests. IFRS 6.21 requires an accounting policy to be developed for the allocation of E&E assets to CGUs (or groups of CGUs) for the purposes of an assessment for impairment. However, each CGU (or group of CGUs) is not permitted to be larger than an operating segment as determined in accordance with IFRS 8 *Operating Segments*.

There is an important distinction to be drawn between an operating segment, and a reportable segment. Although reportable segments are included in the segment disclosures to financial statements, these can be made up of a number of operating segments which have been combined. Consequently care is required if CGUs are grouped for the purposes of impairment, as it is not possible simply to look to the segmental disclosures in an entity's financial statements when considering whether a particular aggregation is acceptable.

Once the accounting policy for the allocation of E&E assets to CGUs (or groups of CGUs) has been determined, this approach is required to be applied consistently from one reporting period to the next. A change in accounting policy is only permitted if the criteria in IAS 8 for a change are met.



BDO comment

Although it might appear attractive to allocate E&E assets to a group of CGUs (to the extent permitted by the constraint placed on this by IFRS 8 – see above) for the purposes of impairment, this can give rise to practical issues. In particular, it might well increase the frequency with which the group of CGUs needs to be tested for impairment and could result in larger charges for impairment. There are two scenarios which illustrate this point:

1) Grouping projects that are close to commercial development with start-up projects

When an E&E asset moves into the development phase, IFRS 6.17 requires an impairment test to be carried out. Consequently, as each project moves to its commercial development phase, an impairment test of the entire CGU in which the asset is included will be required.

2) Grouping projects that have a higher risk of being unsuccessful with ongoing E&E projects

Each time a project is found to be unsuccessful, IFRS 6.20 requires an impairment test to be carried out. Consequently, each time a higher risk E&E project does not lead to the discovery of commercially viable quantities of mineral resources, an impairment test of the entire CGU in which the asset arising from the project is included will be required.

Example, possible scenarios and questions

Company A is exploring for oil in a known oil basin in West Africa. The oil basin stretches across the borders of countries X and Y. Company A is carrying out E&E activities in both countries and, out of 40 specified exploration areas, has the rights to areas 1, 2, 20, 26, 27 and 40. Areas 1, 2 and 20 are located in country X, and areas 26, 27 and 40 are located in country Y. Areas 1 and 2 are adjacent to each other, as are areas 26 and 27, and 20 and 40.

Scenario 1

Company A has started to drill a planned total of 1,000 test wells in area 26. Five wells have been completed, with only water having been found. Company A intends to continue with its test drilling.

Question

Does the failure of the first five test wells to find oil represent an impairment trigger under the requirements of IFRS 6.20?

Answer

This question will typically arise when an entity follows a policy of capitalising all eligible E&E expenditure. Under this approach, the unit of account for the purposes of accounting for E&E assets could be determined as being the area over which Company A has a right to explore. Because Company A intends to continue its E&E activities in area 26, this indicates that an impairment trigger has not occurred. The costs associated with the five test wells are carried forward as an E&E asset, on the basis that the results of drilling provide useful information about the licence area as a whole.

Scenario 2

Company A has completed drilling its planned 1,000 test wells in area 20. Although the results indicate the presence of hydrocarbon reserves, Company A concludes that it will not actively bring area 20 into production due to an unfavourable tax and regulatory regime that has been implemented in country X. However, Company A does intend to continue E&E activities in the adjacent area 40, which is located in country Y. The decision to continue E&E activities in area 40 is partly based on the results of test drilling in area 20.

Question

Is Company A's decision not to continue to production in area 20 a trigger for an impairment test? (A linked and relevant question, which needs to be answered first, is whether areas 20 and 40 can be viewed as being a single unit of account, despite the fact that they are in different countries).

Answer

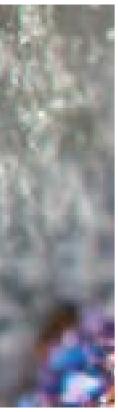
Determination of the unit of account is not defined in IFRS 6, and constitutes a key judgement. Many entities view the unit of account to be the area of interest (and so will apply either area-of-interest or full cost accounting for the purposes of their E&E assets). An area of interest can be based on a geological feature that lends itself to a unified exploration and development effort, and can be made up from a number of adjacent geographic areas that have separate licences attached to them. Consequently, it could be argued that areas 20 and 40 constitute one combined area of interest, and that there has been no trigger for an impairment test.

Reversal of impairment

After a charge for impairment has been made, this is reversed for assets other than goodwill (that is, capitalised E&E assets and property, plant and equipment) if there is a subsequent increase in the recoverable amount calculated in accordance with IAS 36.

Example

Company B is carrying out E&E activities in country X. A requirement of the licence to carry out E&E activities is that Company B incurs a specified minimum amount of exploration expenditure in each year. Due to a collapse in investor confidence, Company B determines the end of its financial year that it is unlikely that it will be able to raise sufficient funds to meet the minimum spending requirement. Consequently, a charge for impairment of its E&E asset is included in its financial statements.



Shortly after the financial statements have been approved, the government of country X grants a three year exemption from the minimum spend requirement.

In this case, the reason for the original charge for impairment has been eliminated. Provided Company B now expects to continue to carry out E&E activities and there are no other indicators of impairment that need to be considered, the original charge for impairment is reversed.

However, the ability to reverse an impairment loss is dependent on the original asset not having been derecognised. In some circumstances, E&E activities may not result in the discovery of mineral reserves and E&E activities are abandoned. In these circumstances, the E&E assets are derecognised and any subsequent developments, such as the discovery of mineral reserves due to improved technology, will not result in a reversal of the impairment charge for the previous E&E assets that have been derecognised.

E&E assets are also derecognised if, for example, an entity loses the right to explore in a specific area.

Example

Company A is carrying out E&E activities in country Z. Due to a change of government, all existing licences for E&E and mining activities are cancelled and the State takes control of all projects. Consequently, Company A abandons its E&E projects in country Z, and impairs and derecognises the related E&E assets.

Five years later, following another change in government, Company A secures new rights to carry out E&E and mining activities. Although future E&E expenditure is eligible for capitalisation (assuming that this is Company A's accounting policy), the impairment of the original E&E asset cannot be reversed, even if the area being explored is the same as the original E&E asset was derecognised.

Frequently asked questions

Question 11

Company A has a 31 December financial year end, with its annual report being approved in March 20X3. An exploratory drilling programme was undertaken during the period from October 20X2 to January 20X3, with the results being evaluated in February 20X3. The analysis shows that no commercial deposits exist and Company A determines that it will cease to carry out E&E activities.

Is Company A required to include a charge for impairment of the E&E asset in its financial statements for the year ended 20X2?

Answer

Yes. Because the test results provide information about the exploration area about conditions that existed at the financial year end (there are no commercial deposits), all E&E expenditure that has been capitalised up to 31 December 20X2 is required to be written off.

Question 12

As a variation on question 10, would the answer change if the exploratory drilling programme was not carried out until the early part of 20X3?

Answer

No. The E&E asset recorded at 31 December 20X2 would be written off, because the test results obtained in early 20X3 provide information confirming that, at 31 December 20X2, there were no commercial deposits. However, the costs of the exploratory drilling programme would not be accrued at 31 December 20X2, instead being expensed in the year ending 31 December 20X3.

Disclosure

IFRS 6.23-25 set out a number of specific disclosure requirements. The overall requirement is for an entity:

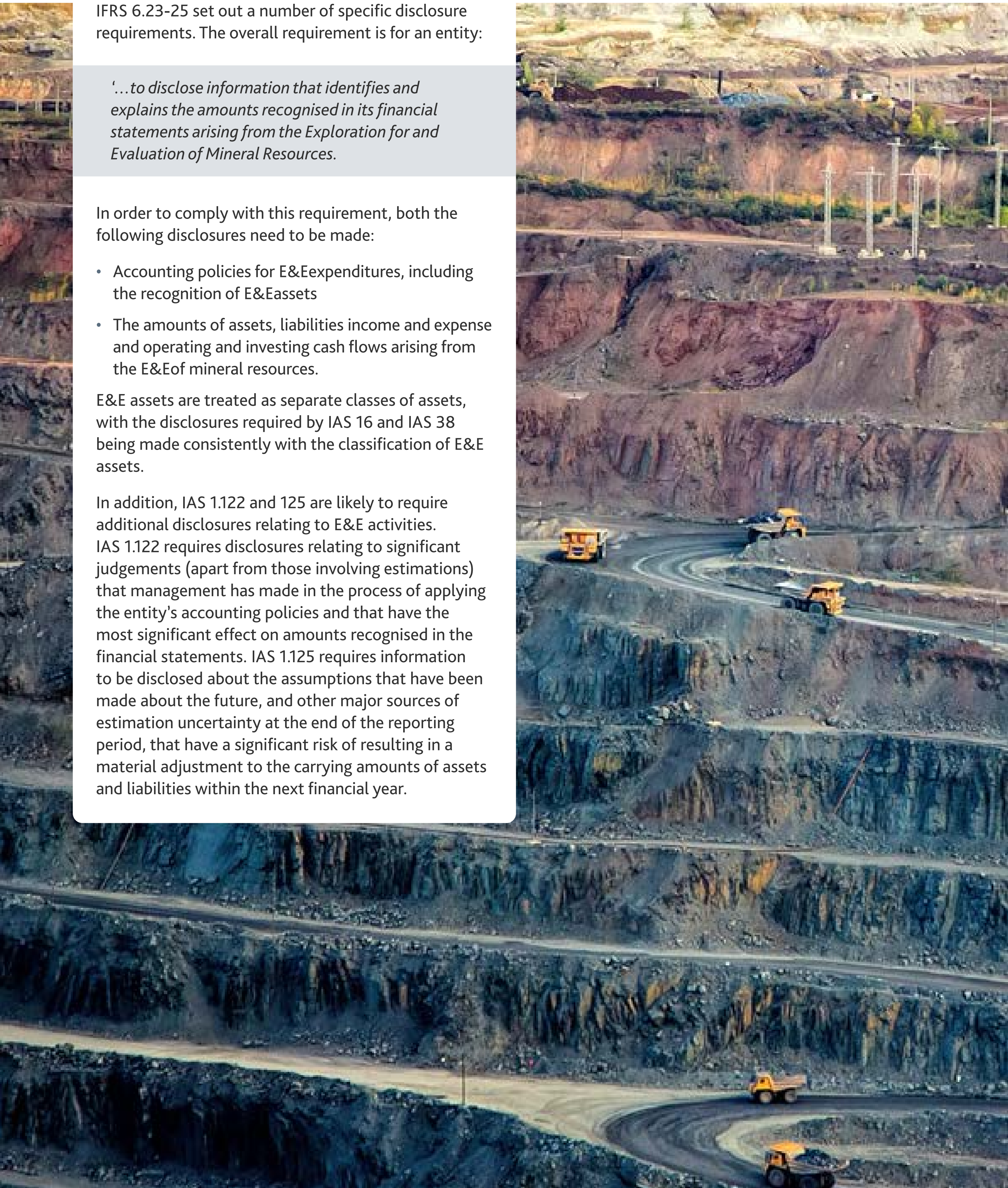
> *'…to disclose information that identifies and explains the amounts recognised in its financial statements arising from the Exploration for and Evaluation of Mineral Resources.*

In order to comply with this requirement, both the following disclosures need to be made:

- Accounting policies for E&Eexpenditures, including the recognition of E&Eassets
- The amounts of assets, liabilities income and expense and operating and investing cash flows arising from the E&Eof mineral resources.

E&E assets are treated as separate classes of assets, with the disclosures required by IAS 16 and IAS 38 being made consistently with the classification of E&E assets.

In addition, IAS 1.122 and 125 are likely to require additional disclosures relating to E&E activities. IAS 1.122 requires disclosures relating to significant judgements (apart from those involving estimations) that management has made in the process of applying the entity's accounting policies and that have the most significant effect on amounts recognised in the financial statements. IAS 1.125 requires information to be disclosed about the assumptions that have been made about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.



Farm in arrangements

It is common for entities involved in the E&E phase (and other phases) of extractive activities to enter into 'farm in' arrangements with third parties. Under a farm in arrangement, an entity engaged in E&E activities (the farmor) gives up the right to future reserves in exchange for a reduction in future funding obligations which will be met by another party (the farmee). In addition to costs being shared among entities, one of the drivers for these arrangements is to share the risks associated with the extractive project with one or more other parties.

The arrangements result in the transfer of a proportion of a property in exchange for a commitment from the farmee to fund certain obligations. Consequently, from the farmor's perspective, a farm in arrangement represents the complete disposal of a proportion of a property.

IFRS 6.4 notes that:

> *'The IFRS does not address other aspects of accounting by entities engagement in the Exploration for and Evaluation of Mineral Resources.'*

This brings the question of whether farm in arrangements fall within the scope of IFRS 6. However, because these arrangements result in the recognition by the farmee of E&E activities and (potentially) a disposal of part of an E&E asset by the farmor, we consider that IFRS 6 is not precluded from being applied to these arrangements.

The approach followed in practice is often based on the approach that many entities previously applied under their own national GAAPs. In summary:

- The farmor will not record any expenditure (whether this would otherwise have been capitalised or expensed immediately) that is settled by the farmee
- The farmor does not recognise a gain or loss on the basis of the partial disposal of any E&E asset that has already been capitalised. Instead, any proceeds received that are not attributable to future expenditure are simply credited against the carrying amount of any existing E&E asset
- To the extent that the proceeds received from the farmee exceed the carrying amount of any E&E asset that has already been capitalised by the farmor, this excess is recognised as a gain in profit or loss.

Example 1

Company A owns 100% of the rights to explore and mine area Z, and has spent and capitalised Currency Units (CU)1,000 to date. Company A (the farmor) enters into an agreement under which it sells 25% of the property to Company B (the farmee) for CU1,000

The proceeds are set against the carrying value of the E&E asset:

Dr Cash	CU1,000
Cr E&E asset	CU1,000

Example 2

Company A owns 100% of the rights to explore and mine area Z, and has spent CU1,000 to date, of which CU500 has been capitalised as an E&E asset. Company A (the farmor) enters into an agreement under which it sells 25% of the property to Company B (the farmee) for CU1,000

The proceeds are set against the carrying value of the E&E asset to the extent of its carrying amount, with the excess being credited to profit or loss:

Dr Cash	CU1,000
Cr E&E asset	CU500
Cr Other income	CU500

Contact

For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below.

Alternatively, please visit www.bdo.global where you can find full lists of regional and country contacts.

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