

Accounting alert

Analysis of the latest accounting developments delivered to you via e-mail

Accounting for exploration and evaluation under IFRS

The International Accounting Standards Board (IASB) and Australian Accounting Standards Board (AASB) have released Exposure Drafts on accounting for the exploration and evaluation of mineral resources.

This *Accounting Alert* provides an overview of these developments.

Overview

IASB ED 6 *Exploration for and Evaluation of Mineral Resources* (ED 6) has been developed by the IASB as a short-term measure to provide guidance on the treatment of exploration and evaluation expenditures. ED 130 *Request for Comment on IASB ED 6 Exploration for and Evaluation of Mineral Resources* is the equivalent AASB Exposure Draft in the Australian context.

The main proposals in the exposure drafts are as follows:

- entities will be permitted to continue their previous accounting policies in respect of exploration and evaluation
- all exploration and evaluation assets would be subject to an impairment test under IAS 36/AASB 136 *Impairment of Assets*, with an option to use a modified 'cash generating unit for exploration and evaluation assets' when assessing impairment.

It should be noted that accounting for other extractive industries related activities (such as development, construction, production and restoration) are not included in within the scope of ED 6 and ED 130. Therefore, Australian reporting entities will have to apply other so-called Australian International Financial Reporting Pronouncements to determine the accounting for the other phases of their extractive industry operations. The appendix to this *Accounting Alert* provides an overview of the main differences between the existing AASB 1022 *Accounting for Extractive Industries* and International Financial Reporting Standards (IFRS).

The comment periods for the exposure drafts close shortly. We have outlined some of the potential issues arising from the exposure drafts in the following pages to assist entities that may be impacted by the proposals to finalise their responses to both the AASB and IASB.

Applying the recoverable amount test

Under the proposed Australian equivalent to IAS 36, recoverable amount will be determined based on the higher of 'fair value less costs to sell' and 'value in use'.

ED 6 does not propose to exempt exploration and evaluation assets from the recoverable amount test, nor does it propose to amend the definition of recoverable amount. However, entities will have the choice of testing exploration and evaluation assets as part of a 'cash generating unit for exploration and evaluation assets'.

Entities that do not elect to use the revised basis are required to apply an annual impairment test to exploration and evaluation assets in accordance with the 'normal' requirements of IAS 36.

AASB 1022 effectively provided an exemption from the recoverable amount test where the exploration efforts were at a point too soon to assess recoverability. As a result, these proposals may impose a significant burden on some entities in the extractive industries sector.

Entities can elect to continue with existing accounting policies for exploration and evaluation assets subject to impairment testing

The exposure drafts have a narrow scope

No exemption from recoverable amount testing, but an optional modification to the cash-generating unit is proposed

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Value in use for exploration and evaluation in itself may often be close to zero or even negative	<p>Does exploration and evaluation have a ‘value in use’?</p> <p>The determination of ‘value in use’ under the proposed revised IAS 36 is very prescriptive, and may effectively result in a value of use close to or equal to zero in many cases. This is because future cash flows included in the measurement of value in use must be determined without reference to future capital expenditure, based on budgets, and so on.</p> <p>Unless a project is at a very advanced stage, or capitalised exploration can be allocated to other cash-generating units, some might argue that expected cash outflows arising from budgeted exploration and evaluation expenditure should be taken into account when determining value in use, leading to a value in use that may even be negative. It is unclear whether this future expected exploration expenditure could be considered capital expenditure of a type that would be excluded from the value in use calculation under the requirements of IAS 36.</p> <p>Alternative 2 in the example below illustrates this issue in relation the ‘cash generating units for exploration and evaluation assets’ alternative of measuring impairment. Whilst we do not believe that this outcome is the intention of the exposure drafts, some clarification would be welcome in the final IFRS.</p>
The nature of exploration and evaluation expenditure as tangible or intangible is not addressed, leading to differences in opinion about the ability to determine ‘fair value’	<p>Does exploration and evaluation have a readily determinable ‘fair value’?</p> <p>There has been considerable debate as to the nature of exploration and evaluation expenditure and the impacts that this nature has on the determination of ‘fair value’. The IASB has noted this debate but does not seek to provide any guidance on this issue as part of ED 6.</p> <p>Some commentators argue that exploration and evaluation does not have a readily determinable ‘fair value’, as each exploration right is akin to a unique intangible asset whose fair value cannot be determined by reference to the value of other assets.</p> <p>Other commentators argue that exploration and evaluation is more akin to a tangible asset, and point out that in many major mining, and oil and gas areas of the world, there are sufficient exchange transactions occurring to allow the determination of fair value.</p> <p>We believe that many exploration and evaluation assets do have a readily identifiable fair value, particularly if mineralisation has been identified or the exploration rights are in a prospective area or close to an existing operating mine or field. The determination of the fair value of so-called ‘green fields’ exploration in relatively unexplored and unknown areas may be more difficult, particularly in the absence of identified prospectivity or indications of potential mineralisation.</p>
Can the concepts of ‘value in use’ and ‘fair value less costs to sell’ be mixed when applying the modified recoverable amount test?	<p>Using a ‘cash generating unit for exploration and evaluation assets’</p> <p>The exposure drafts propose an option to allow entities on initial adoption of the Standard, to elect to test the impairment of exploration and evaluation on the basis of a ‘cash generating unit for exploration and evaluation assets’.</p> <p>Under this approach, the carrying amount of exploration and evaluation assets is added to the carrying amount of other cash generating units (CGUs) when performing the impairment test. The CGU must pass the recoverable amount test before and after the inclusion of exploration and evaluation.</p> <p>As noted above, the value in use of exploration and evaluation assets might often be close to zero, but in many cases the asset may have a fair value on which its recoverable amount could be based. However, the fair value of the CGU to which the exploration and evaluation asset is added may not be readily determinable and it may have been assessed based on a value in use calculation.</p> <p>The interaction of the ‘value in use’ and ‘fair value less costs to sell’ concepts may cause the modified impairment testing approach to result in perhaps unintended write downs of exploration and evaluation assets. In finalising any IFRS resulting from ED 6, the IASB may need to address whether the recoverable amount of the underlying CGU can be determined on a ‘value in use’ basis at the same time as the recoverable amount of ‘exploration and evaluation is determined on a ‘fair value less costs to sell’ basis.</p>

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Example

An entity has a CGU 'ABC' which has a carrying amount of \$100 and has been assessed for impairment based on a value in use of \$120. The fair value less costs to sell of ABC has not been determined. It also has capitalised exploration and evaluation of \$50 which has a fair value of \$40. Budgeted future exploration expenditure amounts to \$30 (on a discounted basis). The entity has elected to test exploration and evaluation using a 'cash generating unit for exploration and evaluation assets' which is based on the ABC CGU and the capitalised exploration and evaluation.

The calculation of the impairment test could be determined as follows:

	Value in use <i>Alternative 1⁽¹⁾</i>	Value in use <i>Alternative 2⁽²⁾</i>	Fair value less costs to sell	'Mixed' approach' <i>(3)</i>
Carrying Amount				
ABC CGU	100	100	100	100
Exploration and evaluation	50	50	50	50
	150	150	150	150
Recoverable amount				
ABC CGU	120	120	<i>unknown</i>	120
Exploration and evaluation	<i>nil</i>	(30)	40	40
	120	90	<i>unknown</i>	160
Impairment loss implied	30	60	<i>unknown</i>	<i>none</i>

- (1) This alternative assumes that future expected exploration and evaluation expenditure is not taken into account in the value in use calculation, meaning the value in use of the exploration and evaluation asset is taken to be effectively zero.
- (2) This alternative assumes that future expected exploration and evaluation expenditure is taken into account in the value in use calculation. Under this alternative, the recognition of substantial impairment losses can result. It is unclear how the amount of any impairment loss over and above the separate carrying amount of the exploration asset would be treated.
- (3) This alternative shows the impact of allowing a 'mixed' approach, whereby the recoverable amounts of the ABC CGU and the exploration and evaluation asset components of the modified CGU are determined by reference to 'value in use' and 'fair value less costs to sell' respectively. This approach produces a recoverable amount closer to the overall 'economic value' of the modified CGU.

Without the ability to combine value in use and fair value when determining recoverable amount for the wider CGU, the entity would be required to perform a 'fair value less costs to sell' calculation for the combined CGU in order to avoid the recognition of an impairment loss, even though this was not required for the separate impairment test applied to the ABC CGU itself.

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Impairment losses previously recognised might be required to be reversed if exploration and evaluation efforts are ultimately successful	<p>Reversal of impairment losses</p> <p>IAS 36 requires the reversal of past impairment losses recognised in certain circumstances. Where an entity's policy for exploration and evaluation under the proposals in the exposure drafts is to capitalise all such expenditure, it could potentially be required to reverse past impairment losses on successfully identifying reserves in a subsequent reporting period. This outcome would not result for entities that choose an accounting policy of immediately expensing exploration and evaluation expenditure.</p>
The impact on junior exploration companies can potentially be very severe.	<p>Impact on so-called 'junior explorers'</p> <p>In effect, the proposals in ED 6 provide entities with a free choice of accounting policy on exploration and evaluation so long as the carrying amounts of all the entity's assets do not exceed their combined recoverable amounts. In other words, the 'excess' value of other assets can effectively be used to support exploration and evaluation assets.</p> <p>This approach causes additional issues where entities are effectively 'junior exploration' companies and do not have other operations or assets on which to support the carrying amount of assets. This situation combined with the problems of determining recoverable amount noted above, may effectively require the write off of all capitalised exploration and evaluation. This may also result in other assets, such as property, plant and equipment and corporate assets being written down to their scrap/sales value due to a lack of cash flows on which to support their carrying amount on the basis of a 'value in use' calculation. This impact can potentially continue even where development has commenced, as the cash flows from future capital expenditure can only be taken into account in the value in use calculation in certain circumstances.</p> <p>In some cases, we believe that there may be some support for these entities deriving a 'fair value less cost to sell' based on their listed share price, so long as they only effectively have one segment to meet the other criteria in the exposure drafts. However, many such entities may be valued at the market at close to their 'cash' value and the prospect of measuring assets based on variable share prices may not appeal to these entities.</p>
Should acquired exploration and evaluation be treated in a manner consistent with IPR&D?	<p>Issues not addressed by the exposure drafts</p> <p>There are a number of matters that arise in the extractive industries or under ED 6 that have not been dealt with in the exposure drafts. Some of the more significant issues are outlined below.</p> <p>Acquired exploration and evaluation assets</p> <p>The exposure drafts do not fully address the accounting treatment for acquired exploration and evaluation assets.</p> <p>Where an entity purchases an exploration and evaluation asset, either directly or through a business combination, it is unclear how an entity's accounting policy is to be applied, particularly where an entity chooses to immediately expense exploration and evaluation expenditure.</p> <p>Some commentators argue that acquired exploration and evaluation should be treated in the same manner as other expenditure, and should be written off or capitalised in accordance with the entity's accounting policy.</p> <p>Other commentators argue that acquired exploration and evaluation expenditure should be capitalised as an asset where appropriate, in a manner akin to acquired in-process research and development (IPR&D) under the proposals in ED 3/ED 109 <i>Business Combinations</i>.</p>
Amortisation calculations using future capital expenditure may be prohibited under IFRS	<p>Amortisation of extractive industries assets</p> <p>Under AASB 1022, it is common practice for amortisation of assets used in the extractive industries to be based on a depreciable amount that includes expected future capital expenditure.</p> <p>The draft standard proposes to continue the scope exemption for mineral rights and mineral reserves in IAS 16 <i>Property, Plant and Equipment</i> and the scope exemption for development in IAS 38 <i>Intangible Assets</i>. However, without an expansion of the framework and other exemptions in ED 6, entities may be faced with using depreciation methods for exploration, evaluation and development that are consistent with those Standards.</p> <p>Furthermore, there are no scope exemptions in relation to those other assets used in the extractive industries operation, such as property, plant and equipment in the form of mills, well heads, mining and production facilities and so on.</p> <p>These areas have the potential to result in significant adjustments on IFRS convergence for Australian entities operating in the extractive industries.</p>

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The impact of the modified impairment test on subsequent phases of the operation are unclear

AASB comments due 19 March, IASB comments due 15 April

The proposals are a 'stop gap' measure pending a comprehensive IASB project

Treatment of exploration and evaluation assets on movement to the development phase

Many entities effectively 'transfer' capitalised exploration and evaluation assets to another asset, development or mine property, when the development phase is commenced. It is unclear in the exposure drafts at what point it is no longer appropriate to use the modified CGU approach for impairment testing of these assets.

Comment period

The IASB has requested comments on ED 6 by 15 April 2004. The AASB has requested comments on ED 130 by 19 March 2004 so that comments received can be taken into account in the AASB's own submission to the IASB on ED 6.

Further developments

The proposals in ED 6/ED 130 are a short-term measure to make limited improvements to accounting for exploration and evaluation, without requiring major changes that may be later reversed.

The IASB is expected to undertake a comprehensive review of accounting practices in the extractive industries at some point in the future, building on the work done by the antecedent IASC. However, given the large number of other IASB projects that have not yet been completed, it may be some time before further changes are proposed in this area.

Feedback and assistance

We welcome your feedback on the matters covered in this *Accounting Alert* – please email your comments to accounting_alerts@deloitte.com.au.

For assistance in determining the impact of the proposed requirements on your organisation, please contact your local Deloitte office or contact our Lead National Technical Partner, Bruce Porter on (03) 9208 7490, or by email to bruporter@deloitte.com.au.

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Appendix: Comparison of AASB 1022 and IFRS requirements

The table below outlines some relevant aspects of existing Accounting Standard AASB 1022 and IFRS that are expected to form the basis of Australian International Financial Reporting Pronouncements (AIFRPs). It does not cover all aspects of AASB 1022 or accounting for the extractive industries, but provides a high-level overview of some of the impacts of IFRS convergence on accounting for the extractive industries in the Australian context.

Area	AASB 1022	IFRS	Comments
General			
Basis of accounting for extractive industries	Area of interest basis	No particular approach is mandated or suggested	IFRS approach is consistent with the objective of ED 6 not to mandate a particular approach
Exploration and evaluation			
Treatment of exploration and evaluation expenditure	Written off as incurred, except that may be carried forward provided that rights to tenure of the area of interest are current and either: <ul style="list-style-type: none"> costs are expected to be recouped through development and exploitation or by sale; or activities are continuing but have not yet reached a stage where an assessment of economically recoverable reserves can be made 	Existing accounting policies in financial report prior to the adoption of the IFRS resulting from ED 6	AASB is expected to reissue AASB 1022 to deal with exploration and evaluation only and this Standard might be expected to carry forward the existing Australian approach under AIFRPs
Treatment of general and administration expenditure	Direct costs can be included in capitalised exploration. Indirect expenditure must be expensed in the period in which it is incurred	Cannot be included in the initial measurement of exploration and evaluation assets	The guidance provided into ED 6 is not as specific as AASB 1022 and could result in differing interpretations of what is eligible for capitalisation into exploration and evaluation.
Impairment testing for exploration and evaluation	Required for each area of interest, but effectively only required where activities are at a stage where it is known that costs can be recouped through successful development and exploitation or by sale	Required for all exploration and evaluation, can be on the basis of a 'cash generating unit for exploration and evaluation' or the normal approach under IAS 36	Significant widening in scope, impact may vary if many areas of interest can effectively be included in a 'cash generating unit for exploration and evaluation assets'
Amortisation of mining related assets			
Depreciable amount	All exploration, evaluation and development costs carried forward	Costs less residual value	Should not result in major differences, as residual value would be expected to be minimal or zero
Treatment of future development costs	Included in depreciable amount where necessarily incurred for the extraction of recoverable reserves used in the depreciation calculation	IAS 16 would require a 'component asset' approach to property, plant and equipment, and would not permit future costs to be included in the depreciable amount. IAS 38 has a scope exemption for expenditure on the development and extraction of non-regenerative resources, but also would not permit expected costs to be included in depreciable amount	Whilst IAS 38 does not apply to development costs, the hierarchy in IAS 8 may imply that the inclusion of these costs in the depreciable amount may be controversial and contrary to the Framework. The amortisation of mining-related property, plant and equipment would need to be in accordance with IAS 16
Amortisation approach	Units of production basis for each area of interest, unless a time basis is more appropriate and the resultant rate of amortisation does not lag the depletion of recoverable reserves	Systematic allocation of depreciable amount over its useful life	Difference in terminology should not result in a different outcome

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Removal and restoration costs			
Basis of recognition	Where necessitated by extractive industries activities, provided for as part of the cost of the respective phase(s) of operation	IAS 37 requires the recognition of a provision where there is a present obligation, such amount can be capitalised into the asset in some cases	IAS 37 approach is much more rigorous and leads to full recognition of the provision (on a discounted basis) at the time the present obligation arises. Many entities currently provide for an undiscounted estimate of the provision over the life of the extractive industries operation on a units-of-production basis
Disclosures			
Disclosures required	Aggregate amount of exploration, evaluation and development costs incurred and written off in the period. Amount of amortisation during the period. Government royalties paid and payable on sales during the period	Accounting policies for exploration and evaluation Amounts of assets, liabilities, income and expense and cash flows Level at which the entity assesses exploration and evaluation assets for impairment	Accounting policies would currently be disclosed under AASB 1022. ASX listed mining exploration entities have additional disclosure requirements under the ASX Listing Rules and it is expected that these requirements will be retained