IFRS Accounting

Staff paper

Agenda reference: 19A

IASB® Meeting

Date	**July 2023**
Project	**Extractive Activities**
Topic	**Summary of feedback—Information to help understand how entities account for E&E expenditure**
Contacts	Vikash Kalidas (vkalidas@ifrs.org) Tim Craig (tcraig@ifrs.org)

Purpose and structure

1. As explained in Agenda Paper 19, this paper summarises feedback from our research on suggestions to improve information about how entities account for exploration and evaluation (E&E) expenditure.

2. This paper is structured as follows:

   (a) Background (paragraphs 3–8);

   (b) Summary of feedback (paragraphs 9–42); and

   (c) Appendix.

Background

3. There is diversity in the accounting policies entities apply to E&E expenditure (see previous research included in Agenda Paper 19A to the IASB's October 2020 meeting and Agenda Paper 19B to its July 2020 meeting).

4. In September 2021 the International Accounting Standards Board (IASB) decided not to address the diversity in accounting policies. The IASB decided it lacked sufficient

evidence to suggest the benefits of reduced diversity in accounting for E&E expenditure would outweigh the costs. However, it decided to explore developing requirements or guidance to improve the disclosures about an entity's E&E expenditure and activities to provide more useful information to users. In making these decisions the IASB considered that transparency of information about E&E expenditure, in particular the accounting policies for E&E expenditure, was important because of the diversity and the significant judgements involved.

5. Our research identified three features of accounting policies for E&E expenditure that are sometimes unclear and could be improved (see paragraphs 7–37 of Agenda Paper 19C to the IASB's September 2022 meeting):

   (a) unit of account;

   (b) E&E expenditure; and

   (c) when capitalisation starts and stops.

6. As explained in Agenda Paper 19, we performed further outreach with various stakeholders, to understand whether and how entities can disclose better information about the different accounting policies entities apply to E&E expenditure, specifically in relation to these three features.

7. Using a generic example of an accounting policy for E&E expenditure, we provided stakeholders with an illustration of aspects of accounting policies which are sometimes not clear and for which more information is sometimes disclosed. We also provided two examples of how differences in accounting policies can affect financial statements to illustrate why understanding those differences might be useful (see appendix).

8. We asked for feedback about:

   (a) whether users are interested in better understanding how entities account for E&E expenditure;

(b) whether sufficient information is disclosed about entities' accounting policies for E&E expenditure;

(c) whether understanding the differences in financial statements of entities applying different accounting policies for E&E expenditure illustrated in the materials would be helpful; and

(d) whether there are any concerns with providing more information about the details of accounting for E&E expenditure.

Summary of feedback

9. Because of the interrelationships between the questions in paragraph 8(a)-(d) we have not separated out feedback on each of those questions. Instead, we have grouped feedback by stakeholder type.

Users

10. Although most users said better information about how an entity accounts for its E&E expenditure could be useful, there were questions about the extent of the usefulness.

11. Many users we spoke with said better information would be useful, for example they said:

(a) transparency of accounting policies is generally helpful and understanding why an entity selected a particular accounting policy would be useful;

(b) understanding the nature of costs included in E&E assets is useful because this affects metrics like EBITDA and cashflows from operations which are used to assess an entity's credit profile;

(c) it could help provide information to assess how conservative an entity's accounting policy is and it could help understand the success of an entity's exploration activities; and

(d) more clarity on how much unsuccessful exploration is carried forward would be useful.

12. However, many users, including those who said better information could be useful, questioned how useful the information would be, and said for example:

(a) they receive sufficient information about entities' accounting policies for E&E expenditure;

(b) information about how entities account for E&E expenditure is of low interest, they use a top-down approach to decide whether to invest and E&E expenditure has a limited effect on their analysis; and

(c) requiring too much detail about accounting policies could increase complexity and make the information less transparent.

13. One user, who has experience of investing in both 'small-cap' (juniors) and 'large-cap' (majors) mining entities, explained why some users might consider accounting policy information to be more important than others. They explained accounting policy information matters less for junior, pre-production, entities because users of these entities' financial statements are more interested in the nature of the activities, the funding of the entity and its liquidity. Users of these entities focus on the cash flow statement rather than the income statement, and how an entity accounts for E&E expenditure is less important. For large mining entities, whose primary activities are focused on production, E&E expenditure is generally not material and consequently, how an entity accounts for E&E expenditure is less important for these entities. However, for mid-sized entities that have both exploration and production activities, information about how they account for E&E expenditure can be more important, especially if they have a significant exploration programme. This is because profit-related metrics (for example, EBITDA and price to earnings) used to value these entities are affected by those entities' accounting policies for E&E expenditure, for example, whether an entity capitalises or expenses its E&E expenditure.

14. The user feedback provided by the two national standard-setters (NSS) was reasonably consistent with our user feedback, although users in one of the jurisdictions were generally more positive towards the suggestion.

15. One NSS reported:

(a) in their jurisdiction there are a large number of 'small-cap' (junior) entities, a moderate number of mid-sized entities and a few 'large-cap' (majors) listed in their market;

(b) users in their jurisdiction do not focus on the financial statements of the 'small cap' entities, whereas financial statements are more important for mid-sized entities and a key focus for the 'large-cap' entities;

(c) there is a wide variety of information provided outside financial statements by entities in the extractive industry in accordance with listing rules in their jurisdiction;

(d) financial statements have potentially less significance than other sources of information for entities engaged in E&E activities, compared to other types of entities, and this can affect stakeholders' views about the financial statements, especially for 'small-cap' entities;

(e) users in their jurisdiction said information about accounting policies, and being able to compare entities, is helpful in the context of using accounting information however this does not tend to be users' main focus; and

(f) users said there is diversity how entities treat unsuccessful exploration and limited information about this, however they said disclosing information to the level of detail suggested about the unit of account could be judgemental and subjective.

16. The other NSS said, in their jurisdiction, users that follow the extractives industry generally follow both large and small-cap entities. This NSS reported that users in their jurisdiction were mostly supportive of improving information about how entities account for E&E expenditure and said:

(a) greater detail about the types of costs capitalised, and why they have been capitalised, might help better understand an entity's E&E accounting policy;

(b) better information about how an entity defines the unit of account in its accounting policy for E&E expenditure might provide decision-useful information regarding the uncertainties and potential of explorations sites; and

(c) better information about when capitalisation starts and stops may provide greater transparency into the entity's approach to capitalising E&E expenditure.

Preparers

17. Overall, preparers said it would be possible to provide additional information about how entities account for E&E expenditure however, they were sceptical about how useful this information would be.

18. Preparers we spoke to said for example:

(a) they receive hardly any questions from users on the accounting for E&E expenditure—users understand the policies;

(b) their policy disclosure includes all material information—additional information would not change users' views;

(c) E&E expenditure is not a material item for many entities—exploration activity is reducing as the entity transitions to 'net zero'; and

(d) there are not many differences between their policy and their peers.

19. Most preparers said it would be possible to provide additional details (see paragraph 5) about their accounting policies for E&E expenditure without significantly increasing costs. However, one preparer said providing a general description of the unit of account is fine, but providing this information at a more granular level might not be practical because of the number of projects they have.

20. Although most preparers were sceptical how useful additional information on how entities account for E&E expenditure would be, some preparers said the information would be useful. Even preparers that were sceptical of the usefulness of providing additional information said in some circumstances some of the information could be useful. These preparers said, for example:

    (a) additional information could improve the comparability of the accounting information;

    (b) without additional information users might not be able to assess how E&E expenditure has affected the financial statements;

    (c) information about the unit of account and nature of the expenditure are important;

    (d) one preparer that expensed geological and geophysical[1] costs, said making it clear which costs are capitalised and which costs are expensed could be helpful;

    (e) more information about whether costs of unsuccessful exploration continue to be capitalised would be useful—although one preparer said users were more interested in information about successful exploration rather than unsuccessful exploration; and

    (f) a minimum set of disclosure requirements could help smaller entities provide better information about their accounting policies for E&E expenditure.

21. The preparer feedback provided by the two NSS was reasonably consistent with our preparer feedback.

22. Preparers (these were predominantly mining entities) who met with one of the NSS said they receive few questions about how they account for E&E expenditure and this may be because:

[1] Geological and geophysical costs are expenditures incurred to obtain and evaluate data for exploration areas and include, for example, costs of seismic studies.

(a) other sources of information outside financial statements are more relevant;

(b) information about future E&E expenditure is more relevant than historical expenditure; and

(c) users want to know what the spend on E&E is—whether the E&E expenditure is expensed or capitalised is not significant to them.

23. The few questions that these preparers did receive from users (these were generally for ‘small-cap’ entities) were about the nature of costs capitalised, for example, how much of the expenditure capitalised related to employee costs to distinguish how much of the capitalised expenditure is ‘true’ exploration and how much relates to administrative costs.

24. Preparers also said entities, whose primary activities are focused on production, generally expense E&E expenditure and the expenditure is not material to their operations.

25. These preparers said additional information about the accounting for E&E expenditure would be useful if E&E expenditure is material and it would be more important for smaller entities. However, preparers also said:

(a) the IASB would need to justify why more detailed disclosure requirements were needed for E&E expenditure compared to other similar forms of expenditure such as research and development expenditure;

(b) the decision to start and stop capitalising E&E expenditure is more of a judgement than an accounting policy;

(c) each entity and their geological structures are different with different costs involved, accordingly understanding any differences in the accounting for E&E expenditure would require context; and

(d) if additional information is required to be disclosed about unsuccessful exploration, the IASB would need to provide guidance on what is meant by unsuccessful exploration—drilling can still provide information about the deposit even if resources are not discovered.

26. These preparers said there were no major concerns with providing this level of detail in their accounting policies for E&E expenditure however, they were sceptical whether this would achieve comparability and whether in some circumstances the information might be commercially sensitive—for example, detailed information about the unit of account and individual exploration projects.

27. The other NSS reported that stakeholders[2] were mostly supportive of providing better information about how entities account for E&E expenditure. These stakeholders said additional information:

   (a) would be most relevant for junior mining entities that have material E&E expenditure and not as relevant for mid to large sized mining entities that have a relatively immaterial spend on E&E activities;

   (b) could reduce diversity by increasing transparency about:

      (i) the judgement of when mining projects are determined to be economically viable for development; and

      (ii) how an area of interest (unit of account) is established;

   (c) is largely available and may not be challenging to provide however, they said the suggestion could result in additional reporting costs for junior mining entities.

Auditors

28. Auditors had mixed views on the usefulness of providing additional information about how an entity accounts for E&E expenditure.

29. One auditor we spoke to said accounting policy information could be improved. They said, in their view, paragraph 24 of IFRS 6 *Exploration for and Evaluation of Mineral Resources* is vague. They also said there are differences between mining and oil and

[2] One NSS reported feedback from preparers, auditors and regulators together and it was not possible to attribute the feedback to specific stakeholder groups. We have included the feedback in the stakeholder group that we think it is most relevant to, but the comments might also be attributable to other stakeholder groups.

gas entities for example, disclosure of accounting policies might be easier for mining entities because of the nature of the activities and because they spend less time on exploration. For oil and gas entities there is more guidance in US Generally Accepted Accounting Principles on how to account for E&E expenditure, and accounting policy information for oil and gas entities could be more detailed than mining because they want to be comparable to peers in the US.

30. This auditor suggested providing a clear disclosure objective together with examples and implementation guidance of what would typically be included in the accounting policy disclosure.

31. Commenting on what particular information might be useful, the auditor said:

(a) a succinct description of the unit of account would be useful;

(b) generally, entities provide information if they are aggregating cash-generating units for impairment testing purposes however, it would be helpful if the IASB could emphasise the importance of disclosing this information;

(c) information about when an E&E asset is reclassified to property, plant and equipment, which is often tied to reserve and resource reporting, would help users understand the link between the financial statements and reserve and resource reporting; and

(d) information about whether E&E assets are tangible or intangible would be useful.

32. Similar to other stakeholders, this auditor said the usefulness of information about how entities account for E&E expenditure depends on the size of the entity. For the largest entities E&E expenditure is not very material—E&E is not a significant activity. However, for junior entities, the majority only have one project and it would therefore be material.

33. On the other hand, the other auditor we spoke to said the information currently disclosed about entities' accounting policies is adequate in the context of well-established accounting practices and materiality. There may be differences in the

accounting policies but these are not likely to be material. Users are not interested in how entities account for E&E expenditure for example, users are more interested in the going concern of junior entities rather than the details of how they account for E&E expenditure. They said information about unit of account is useful but some of this information can be found in other filing or regulatory documents. They also questioned why a different level of detail of disclosure on unit of account would be required for a specific industry.

34. Auditors that one of the NSS spoke to had similar mixed views. These auditors said entities were generally adequately disclosing their accounting policies for E&E expenditure, but more information could be useful for example, information about:

(a) the nature and type of E&E expenditure especially for junior entities;

(b) how the area of interest (unit of account) is defined; and

(c) when an entity starts and stops capitalising however, this auditor said they were not sure users would be interested in this information.

35. These auditors had concerns that more detailed requirements would be imposed in respect of E&E expenditure than similar forms of expenditure such as research and development, and some of the information is available outside the financial statements.

Regulators

36. Regulators were generally supportive of providing additional information about how entities account for E&E expenditure.

37. One regulator we spoke to said although there are well-established accounting practices, disclosure of accounting policies for E&E expenditure are unclear, for example:

(a) for those that capitalise E&E expenditure, it is not clear when they start or stop;

(b) the unit of account for capitalisation is not clear—is it a well, a geographical area, a project containing several fields, and so on;

(c) what is the cash-generating unit for impairment testing purposes—because large cash-generating units could mask impairment; and

(d) entities should disclose if they are carrying forward costs related to unsuccessful activities.

38. Another regulator said additional information about entities' accounting policies for E&E expenditure could be helpful given the diversity of those accounting policies, and that the information needed for smaller entities may be different to the information needed for larger entities that have more production activities.

39. However, that regulator said there is a lot of information provided outside financial statements and describing the unit of account could be difficult without providing information similar to what is provided outside financial statements. They also said the information might not be that useful, and more information would probably not lead to more consistent accounting.

40. Overall, the regulator said on balance, even if users discount this information, better information would be preferable.

41. Regulators one NSS spoke to said generally entities disclose sufficient information to help users understand their accounting policies, but there are some cases of poor information being disclosed, generally in smaller rather than larger entities. However, they said this is a compliance issue rather than a standard-setting issue.

42. These regulators said the additional information would be useful—for example, enhanced information about the nature and type of E&E expenditure and impairment testing. However, they said they had not heard complaints from users about the extent of information on accounting policies. They said preparers should be able to provide the additional information, but a better explanation of unit of account may be needed in IFRS 6.

Question for the IASB
1. Do IASB members have any comments on the feedback summarised in this paper?

Appendix

A1. We included in our outreach materials two examples of how differences in accounting policies can affect financial statements to illustrate why understanding those differences might be useful.

Example one

Fact pattern

A2. Companies A and B have two licenses each and spend Currency Units (CU) 20 exploring each license area. Both entities fail to find economic resources in the first license but are successful in finding economic resources (worth CU 100) in the second license. Applying Company A's accounting policy, both licenses are combined into a single unit of account when accounting for E&E expenditure. Applying Company B's accounting policy, each license is considered a separate unit of account.

Potential financial reporting effect

A3. Company A recognises an E&E asset of CU 40 on its Statement of Financial Position. This will be amortised as a production cost once the asset starts producing. The entity's exploration success rate could be considered to be 100%.

A4. Company B recognises an E&E asset of CU 20 on its Statement of Financial Position (which will also be amortised as a production cost when the asset starts producing) and an impairment loss of CU 20 in its Income Statement. The entity's exploration success rate could be considered to be 50%.

How could better information about how entities account for E&E expenditure help users?

A5. Information about an entity's accounting policy for E&E expenditure could help users to understand:

(a) how E&E expenditure is accumulated—by license, project, well, geological area, and so on;

(b) the (potential for) costs of unsuccessful exploration to be carried forward as an asset; and

(c) how impairment testing is performed for E&E assets.

Example Two

Fact pattern

A6. In exploring an area, Companies A & B incur:

(a) Drilling costs CU 80;

(b) Geological and geophysical costs CU 20;

(c) Overheads directly attributable to exploration CU 10; and

(d) General overheads CU 20.

A7. Applying Company A's accounting policy, (a), (b) and (c) are included in E&E expenditure that it capitalises as an asset. Applying Company B's accounting policy only (a) is included in its E&E asset.

Potential financial reporting effect (in the year the costs are incurred)

A8. Company A recognises an E&E asset of CU 110 in its Statement of Financial Position—if exploration is successful this cost is amortised when the asset is producing—and costs of CU 20 in its Income Statement.

A9. Company B recognises an E&E asset of CU 80 in its Statement of Financial Position—if exploration is successful this cost is amortised when the asset is producing—and costs of CU 50 in its Income Statement.

How could better information about how entities account for E&E expenditure help users?

A10. Information about an entity's accounting policy for E&E expenditure could help users to understand the nature and type of expenditure included in E&E costs and E&E assets.

Overall

A11. Transparency of the diversity in the accounting for E&E expenditure might help users better understand differences in financial reporting.