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IFRS® Standard 6 Exploration for and Evaluation of Mineral Resources

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CASE STUDY – IFRS 6 EXPLORATION FOR AND EVALUATION OF MINERAL RESOURCES

Introduction

Exploration for and extraction of mineral resources is an activity that involves significant financial and time recourses. Moreover, entities involved in this activity face high risks that the projects will not be as profitable as initially planned or even fail. Therefore, the accounting policies related to exploring for and extracting mineral resources require very specific attitude on the setting of accounting rules in such a manner that financial information would be relevant and reliable.

Aim of this case study is to provide an understanding of the essence and methods of treating the expenditures incurred by an entity in connection with the search for mineral resources. This case study addresses the following issues:

- Identification of expenses which are treated as exploration and evaluation expenditures and how they are measured.
- Familiarization with the procedures that should be applied and what are the requirements for disclosure.

The Case Information

Entity A is involved in oil refinery. Taking into account that the process of oil extraction is complicated, and the balance of recoverable oil resources in the wells is limited, entity A is looking for a new area for exploration. Entity A received permission from African country X to conduct research and explore opportunities for oil production in N's area. The following expenditure has incurred related to the exploration of area N:

- In May 20x3, entity A incurred CU5,000 of prospecting expenditures for evaluation of the potential to find some oil in area N.
- In July 20x3, entity A received the legal rights to start the exploration. The license for exploration of area N has cost CU15,000, and is valid for 3 years.
- In August 20x3, entity A purchased the necessary exploitation equipment for CU70,000. The depreciation period for equipment is 5 years.
- In August 20x3, entity A hired a team of employees to work on the exploration and evaluation project for an annual labour cost of CU40,000.
- In December 20X3, entity A purchased additional exploration works from contractors at the cost of CU5,000.
- In December 20X4, the evidence of successful exploration has been obtained, proving that sufficiently large quantities of oil can be extracted from the wells explored. Therefore, in February 20X5, the company has additionally purchased equipment for extracting the oil for a price of CU100,000.

Discussion Questions

1. Which expenditures incurred by entity A may be treated as exploration and evaluation expenditures. Explain.
2. Calculate what will be the value of exploration and evaluation assets by 31.12.20X3, if entity capitalized the exploration and evaluation expenditures as exploration and evaluation assets?
3. What entity A was obliged to do, if during the exploration period, the situation in the market of minerals would change dramatically, resulting in a significant plunge in oil prices?

SOLUTION OF CASE STUDY – IFRS 6 EXPLORATION FOR AND EVALUATION OF MINERAL RESOURCES

1. IFRS 6 is not applicable to expenditure incurred **before** the entity receives the legal rights to explore a specific area and **after** it is proved that it is technically and commercially viable to execute the mining works.

Therefore, the prospecting expenditures for evaluation of potentially finding some oil in area N that incurred in May 20x3 are not related to the exploration and evaluation expenditures as they were incurred before the legal rights to start the exploration were obtained.

The equipment for extracting oil purchased in February 20X5 does not qualify as exploration and evaluation expenditures as well, since this equipment is purchased for the extraction of oil from successfully detected wells.

All other expenditures should be treated as exploration and evaluation expenditures.

2. The expenditures related to exploration and evaluation include obtaining license, the exploitation equipment, labour costs of employees and additional exploration works.

Since the license and exploiting equipment are non-current tangible assets, the part of amortization and depreciation of year 20X3 should be capitalized as exploration and evaluation assets.

Amortization of license for year 20X3 is CU15,000/3 years/12 months x 5 months =CU2,083

Depreciation of exploiting equipment for year 20X3 is CU70,000/5 years/ 12 months x 4 months = CU4,667

Labour costs of employees is capitalized at the amount paid for the period from August to December 20X3 which would be CU40,000/12 months x 5 months = CU16,667

Exploration works are capitalized at all its amount of CU5,000, as these expenses have incurred at once in December 20X3.

Capitalized costs	**July – December 20x3, CU**
License amortization	2,083
Equipment depreciation	4,667
Labour	16,667
Exploring works	5,000
Total value of exploration and evaluation assets	**28,417**

3. In situations when market conditions are changing significantly, the business results of entities involved in the exploration for and extracting of mineral resources may be affected. At the same time, there may occur a situation when the booked value of exploration and evaluation asset may become much higher than its recoverable amount. Therefore, in such cases, the impairment test must be performed, so that the entity would evaluate the impact of the change on the value of its exploration and evaluation assets. Such entity should measure, present and disclose any impairment loss in its financial statements.