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IFRS® Standard 6 Exploration for and Evaluation of Mineral Resources

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IFRS® Standard 6 Exploration for and Evaluation of Mineral Resources

Scope and Key Definitions

The entities involved in the exploring for and extracting of mineral resources are dealing with specific activities that consume significant time and financial resources. It takes a long time from prospecting to extracting the mineral resources. Moreover, there is no guarantee that all the exploring initiatives will eventually be successful. Therefore, there is a high risk that significant investments in exploring a specific area will be unprofitable.

Before issuing IFRS® Standard 6 Exploration for and Evaluation of Mineral Resources, extractive entities used to book exploration and evaluation costs in accounting in diverse ways. It was difficult for information users to compare the financial data between different extracting entities as they followed national accounting principles, which were different among countries.

Even though IFRS® Standards specify how entities should design their accounting policies, yet the entities operating in the extractive industries may face difficulties and uncertainty in determining which accounting policies are acceptable in accordance with the IAS Standard 8 Operating Segments.

IFRS 6, which is effective from 1 January 2006, has been issued to guide the extractive entities through establishing their accounting rules in a way the financial data could be comparable for its users. It is very important to make note that this Standard is strictly applied only for a particular period and cannot be applied to the costs incurred:

a) before an entity receives the legal rights to explore a specific area;

b) after it is proved that it is technically and commercially viable to execute the mining works.

For these periods other IFRS standards must be applied.

<u>Key Definitions (IFRS6.AppendixA):</u>

Exploration for and evaluation of mineral resources – refer to the search for the mineral resources (i.e. minerals, oil, natural gas, etc.). It starts when an entity receives the legal right to look for a mineral resource in a specific area. It ends when the said entity gets a proof that it is technically and commercially viable to explore a mineral resource.

Exploration expenditures – refer to the costs of prospecting works for discovering mineral resources.

Evaluation expenditures – refer to the costs suffered for obtaining proof that it is technically and commercially viable to explore a mineral resource.

Exploration and evaluation assets – refer to the costs that incurred during the period of searching for the mineral resources recognized as assets in accordance with the entity's accounting policy.

Fundamental Issues: Recognition

According to IFRS 6, entities may continue using their accounting policies as long as they are complying with paragraph 10 of IAS® 8 Standard Accounting Policies, Changes in Accounting Estimates and Errors. This means that the policy applied must ensure the provision of relevant and reliable information.

IFRS 6 Standard also allows exceptions for entities to its accounting policy in respect to how an entity chooses to identify and evaluate the exploration and evaluation assets. This means that even if those accounting policies may not be in full conformity with the specific IFRS standards, they are applicable as long as they are relevant and reliable.

Entities are free to decide whether the exploration and evaluation expenditures should be expensed or should they be partly or fully capitalised. Entities must clearly identify this in their accounting policy.

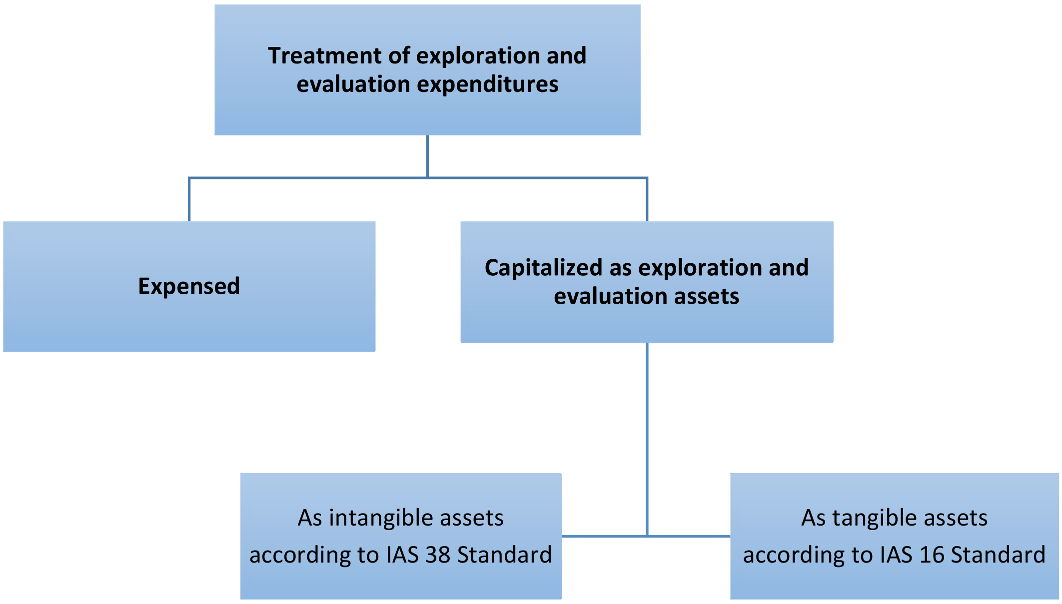

Figure 1. Approach to exploration and evaluation expenditures

As shown in Figure 1, if an entity chooses the capitalization, then it should group exploration and evaluation assets into tangible assets or intangible assets. The entity must evaluate the nature of the assets acquired and apply the classification consistently. For tangible assets, the rules of IAS® Standard Property, Plant and Equipment are applied. The rules of IAS Standards Intangible Assets are applied on intangible assets.

When tangible assets are used for the development of intangible assets, the consumed part of the tangible assets is treated as the cost of intangible assets. For example, if an entity carries out some drilling works for assessing possibilities of the mining of the minerals, then these works should be booked as an intangible asset.

Fundamental Issues: Measurement

For the first time, exploration and evaluation assets must be booked **at their purchase cost.**

The entity must describe in its accounting policy which costs are accounted as exploration and evaluation assets. Then the entity should also consider at what degree it is possible to associate expenditures with finding specific mineral resources. For example, the costs that could be capitalised are the costs for obtaining a permission to explore minerals, various surveys of the area of interest, collection and analysis of soil samples, evaluation of possible profitability, etc.

However, development of mineral resources is another phase of the exploration project, and these costs are the subject of the Conceptual Framework for Financial Reporting and IAS Standard Intangible Assets.

Sometimes entities take over the commitments to remove and restore the natural area as they begin exploring and assess the minerals. In such cases, these commitments are booked in accordance with the requirements of IAS Standard Provisions, Contingent Liabilities and Contingent Assets.

The examples illustrating how the exploration cost may be measured are presented in Table 1.

Table 1. Examples of exploration cost measurement.

Types of costs	**Examples**
Tangible Assets	The entity purchased exploration equipment for CU10,000 to develop possible wells of shale gas. Depreciation of equipment over the period is calculated at CU2,000, which is included in intangible assets.
Intangible Assets	The entity acquired a license to explore mineral resources for a period of 2 years and paid CU5,000 for the license. This will be classified as an intangible asset.
Remuneration of Explorers	During the two-year shale gas exploration period, employees were paid CU40,000. This will be classified as an intangible asset.
Total Exploration Cost	The total cost for over two years is CU49,000 (2-year deprecation CU4,000 + license CU5,000 + labour costs CU40,000). For the first time, these exploration costs will be recognized as exploration and evaluation assets in the statement of financial position.

As indicated in Table 1, the depreciation of exploration equipment carried out during the exploration and evaluation period is recorded as intangible exploration and evaluation assets. License and employee salaries are also directly related to the exploration period. Therefore, they are also recorded as the intangible assets of exploration and evaluation. Therefore, by the end of the second year of exploration activity, the exploration and evaluation assets amount to the sum of two-year depreciation of exploration equipment, license obtaining cost and salary costs.

The next step is the decision that needs to be made to determine the model acceptable for the entity to measure the exploration and evaluation assets. As shown in Figure 2, IFRS 6 gives the possibility to choose either cost or revaluation model.

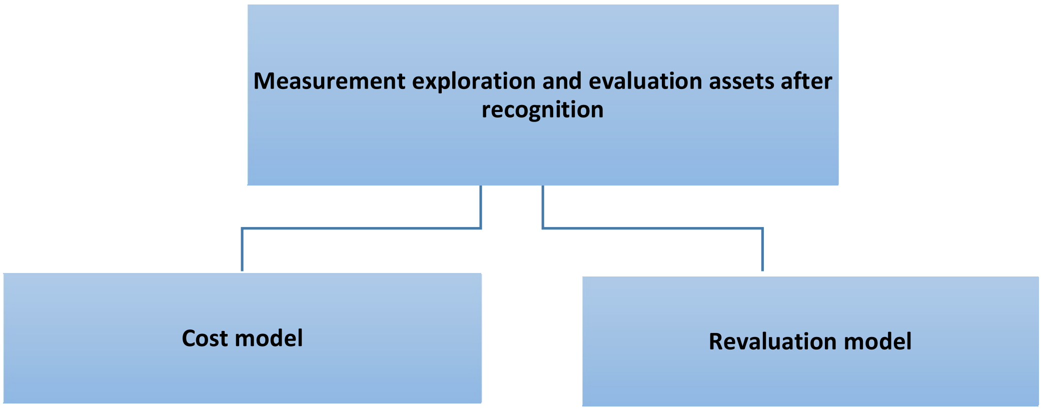

Figure 2. Measurement of exploration and evaluation assets after recognition

If an entity chooses to use the cost model, then exploration and evaluation assets are depreciated to their residual values through their useful economic lives. Regulations on depreciation or amortisation of each tangible and intangible asset are described in the IAS Standard 16 and IAS Standard 38 accordingly.

If an entity chooses to use the revaluation model, then it should also follow guidance for revaluation set in IAS Standard 16 and IAS Standard 38. The only requirement is to book exploration and evaluation assets as a separate class of assets, so it would be easier to perform the purpose revaluation. This allows an entity to choose to apply different measurement models to its tangible and intangible assets. For example, this entity may choose the cost model for tangible assets and revaluation model for intangible assets.

Examples presented in Table 2 illustrate the difference between these two models.

Table 2. Examples of application cost or revaluation models after recognition of exploration and evaluation assets.

Cost model	Revaluation model
For the initial exploration and evaluation, assets were recorded at CU49,000. The entity has chosen to apply the cost method in its accounting policies. After the exploration, a permit was obtained for the extraction of mineral resources for a period of 5 years. Therefore, exploration and evaluation assets will be depreciated in 5 years. Depreciation for one year will be CU9,800 and the value of the assets in the statement of financial position will be CU39,200.	For the initial exploration and evaluation, assets were recorded at CU49,000. Following the revaluation of the exploration and evaluation of mineral resources assets, it was found that similar studies could be carried out at a lower cost (changes in market) during this period. It has been established that such exploration for mineral resources can be carried out for CU38,000. This value (CU38,000) will be presented in the statement of financial position .

As shown in the examples (see Table 2), the value of the same asset in the statement of financial position is different when choosing different measurement models. In practice, the cost model is used considerably more frequently by the exploring entities as it is much easier to apply and does not require additional information to be collected in order to carry out the reliable revaluation procedure.

Fundamental Issues: Procedures

Change of accounting policies

IFRS 6 allows the extracting entities to employ specific recognition and evaluation procedures described in their accounting policies, yet there are still some rules on how they may be changed.

An entity may change its accounting policies for exploration and evaluation expenditures if:

- in relation to the change, the financial reporting becomes more relevant, yet at the same time, it does not become less reliable, or
- in relation to the change, the financial reporting becomes more reliable, but at the same time, it does not become less relevant.

This means that the entity must assure relevance and reliability of its financial data when it makes any changes to its accounting policies. At the same time, IFRS 6 allows changes without achieving the full conformity with these criteria.

Impairment

There may arise a specific situation in the market or some business conditions when the booked value of an exploration and evaluation asset may become much higher than its recoverable amount. In such cases, the procedure of impairment should be performed, and IAS Standard 36 Impairment of Assets would require the entity to recognize an impairment loss.

However, it is difficult to estimate what future cash flows could be generated from the exploration and evaluation assets. Therefore, IFRS 6 indicates specific circumstances when a detailed impairment test must be performed and is less strict than the requirements of IAS Standard 36. Some examples are listed in the IFRS 6 illustrating situations, when the test for impairment must be made:

- the entity's right for prospect in the specific area has expired or will expire in the near future with no renewal;
- the entity has already used its budgeted amount for exploration and additional budget is not planned;
- the entity took a decision to stop exploring activities, as it appeared that it is not technically and commercially viable to explore a mineral resource;
- there is clear evidence that even in case of success, the costs spent on the development will most probably not pay back.

The list is not final, so the entity must evaluate what other conditions may form the background for the impairment test. Other examples could include a significant drop in mineral prices, problems in obtaining sufficient financing for further exploration of mineral resources, unplanned delays in exploration and evaluation, etc.

There is a requirement for an entity to allocate exploration and evaluation assets to cash generating units or groups of cash generating units. This allocation allows performing a more precise impairment. The allocation rules must be described in the accounting policy of individual entities and should be applied in all impairment cases. There are two requirements which specify the size and the level of these units:

- each unit, or a group of units, should not be larger than an operating segment;
- the level may consist of one or more units.

Disclosure

IFRS 6 establishes only the minimal disclosure requirements. The entity may disclose more information, if it considers that such disclosure is needed. The most important requirement is to reveal information that clearly shows what amounts related to the exploration for and evaluation of mineral resources have been recognized in financial reporting.

Figure 3 illustrates the items for disclosure of information in the financial reports related to extracting and evaluation period.

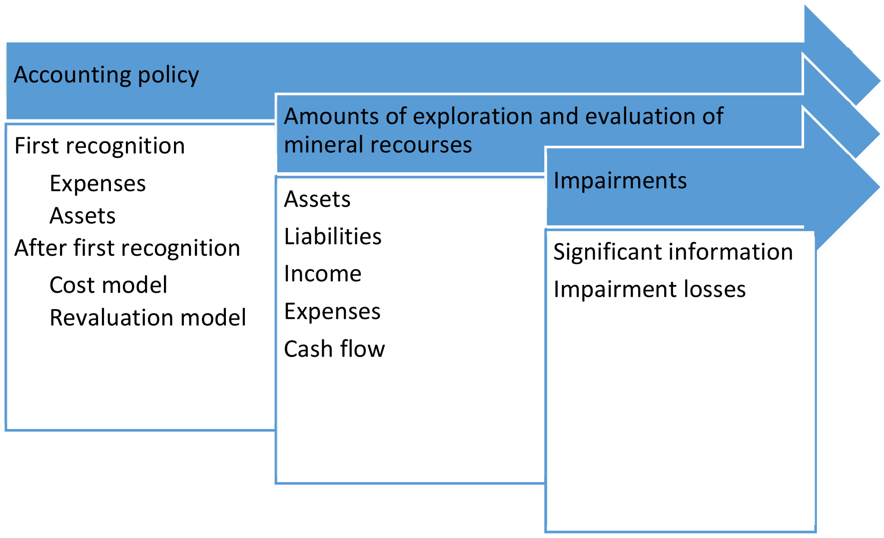

Figure 3. Requirements for mandatory disclosure in the financial reporting

An extracting entity should disclose its specific regulations in the accounting policy, amounts resulting from exploring activities and information on impairment procedures.

Examples

Entity X is involved in oil refinery and is constantly looking for new areas for exploration. This entity has new plans to start oil exploration in Africa. The following economic events are related to the search for a new oil area:

- In April 20x1, Entity X received legal rights to start the exploration from Angola government. The license for exploration of a certain area has cost CU20,000, and is valid for 4 years.

Record in April 20x1 for license Dr. Intangible assets CU20,000 Cr. Cash CU20,000
Record in May – December 20x1 for amortization of intangible assets (CU20,000 / 4 years / 12 months x 8 months) Dr. Exploration and evaluation assets CU3,333 Cr. Intangible assets CU3,333
Record in January – December 20x2 for amortization of intangible assets (CU20,000 / 4 years) Dr. Exploration and evaluation assets CU5,000 Cr. Intangible assets CU5,000
Record in January – December 20x3 for amortization of intangible assets (CU20,000 / 4 years) Dr. Exploration and evaluation assets CU5,000 Cr. Intangible assets CU5,000
Record in January – December 20x4 for amortization of intangible assets (CU20,000 / 4 years) Dr. Exploration and evaluation assets CU5,000 Cr. Intangible assets CU5,000
Record in January – April 20x5 for amortization of intangible assets (CU20,000 / 4 years / 12 months x 4 months) Dr. Exploration and evaluation assets CU1,667 Cr. Intangible assets CU1,667

- In May 20x1, Entity X purchased the necessary exploiting equipment (A) for CU50,000. The depreciation period for equipment is 5 years.

Record in May 20x1 for equipment (A) Dr. Tangible assets CU50,000 Cr. Cash CU50,000
Record in June – December 20x1 for depreciation of tangible assets A (CU50,000 / 5 years / 12 months x 7 months) Dr. Exploration and evaluation assets CU5,833 Cr. Tangible assets CU5,833
Record in January – December 20x2 for depreciation of tangible assets A (CU50,000 / 5 years) Dr. Exploration and evaluation assets CU10,000 Cr. Tangible assets CU10,000
Record in January – December 20x3 for depreciation of tangible assets A (CU50,000 / 5 years) Dr. Exploration and evaluation assets CU10,000 Cr. Tangible assets CU10,000
Record in January – December 20x4 for depreciation of tangible assets A (CU50,000 / 5 years) Dr. Exploration and evaluation assets CU10,000 Cr. Tangible assets CU10,000
Record in January – May 20x5 on depreciation of tangible assets A (CU50,000 / 5 years / 12 months x 5 months) Dr. Exploration and evaluation assets CU4,167 Cr. Tangible assets CU4,167

- In May 20x1, employees for work on the exploration and evaluation project in Entity X were hired. Their yearly labour costs amounts to CU20,000. The employee worked until February 20x5.

Record in May – December 20x1 for labour costs (CU20,000 / 12 months x 8 months) Dr. Exploration and evaluation assets CU13,333 Cr. Cash CU13,333
Record in January – December 20x2 for labour costs Dr. Exploration and evaluation assets CU20,000 Cr. Cash CU20,000
Record in January – December 20x3 for labour costs Dr. Exploration and evaluation assets CU20,000 Cr. Cash CU20,000
Record in January – December 20x4 for labour costs Dr. Exploration and evaluation assets CU20,000 Cr. Cash CU20,000
Record in January – February 20x5 for labour costs (CU20,000 / 12 months x 2 months) Dr. Exploration and evaluation assets CU3,333 Cr. Cash CU3,333

- In July 20x3, Entity X purchased additional exploring works from contractors for the cost of CU15,000.

Record in July 20x3 for exploring works purchase Dr. Exploration and evaluation assets CU15,000 Cr. Cash CU15,000

- In March 20x4, the additional exploiting equipment (B) for CU150,000 was purchased in Entity X. The depreciation period for equipment is 5 years.

Record in March 20x4 for equipment (B) Dr. Tangible assets CU150,000 Cr. Cash CU150,000
Record in January – December 20x4 for depreciation of tangible assets B (CU150,000 / 5 years / 12 months) Dr. Exploration and evaluation assets CU22,500 Cr. Tangible assets CU22,500

- In February 20x5, the evidence of successful exploration was obtained proving that large quantities of oil can be extracted from the wells explored.
- In May 20x5, Entity X sold all rights to explore for CU320,000 to Entity Y.

Record in January – May 20x5 for depreciation of tangible assets B (CU150,000 / 5 years / 12 months x 5 months) Dr. Exploration and evaluation assets CU12,500 Cr. Tangible assets CU12,500

Record in May 20x5 for the sales of rights to explore
Dr. Cash CU320,000
Cr. RevenueCU133,334
Cr. Exploration and evaluation assets CU186,666

Entity X indicated in its accounting policy that all exploration and evaluation costs will be fully capitalized.

It should be noted that if a license is accounted for as an intangible asset, it is thus amortized. Accordingly, fixed tangible assets (those of equipment) are depreciated over their estimated useful lives. Therefore, the costs capitalized of exploration and evaluation will be as follows:

Capitalized costs	**April – December 20x1, CU**	**January – December 20x2, CU**	**January – December 20x3, CU**	**January – December 20x4, CU**	**January – May 20x5, CU**	**Total, CU**
License amortization	3,333	5,000	5,000	5,000	1,667	**20,000**
Equipment (A) depreciation	5,833	10,000	10,000	10,000	4,167	**40,000**
Equipment (B) depreciation				22,500	12,500	**35,000**
Labour	13,333	20,000	20,000	20,000	3,333	**76,666**
Exploring works			15,000			**15,000**
Total Value of exploration and evaluation assets	**22,499**	**35,000**	**50,000**	**57,500**	**21,667**	**186,666**