Accounting for Earn-in Expenditures Prior to Acquisition of a Mining Interest

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In the Canadian junior mining industry, it is common for an entity to acquire a mineral property interest by entering into an earn-in option agreement with the interest holder. Upon incurring a certain amount of expenditures on the mineral property, the entity acquires the mineral property interest. Cash and/or share-based payments may also be due as part of the earn-in. In some cases, an entity acquires a mineral property indirectly by acquiring the shares of the entity that holds the interest. The acquirer should consider which IFRS Accounting Standard applies to this acquisition, including any exploration and evaluation (E&E) expenditures incurred as part of the agreement.

Fact pattern

- A public entity (Entity A) has entered into an earn-in option agreement to acquire 100 per cent of Entity B. Entity B's only asset is a mineral property interest.
- There are no proven or probable reserves to the underlying mineral property of Entity B, and an economic assessment would not be expected to be supportable.
- To acquire 100 per cent of Entity B, Entity A must:
    - pay to Entity B's shareholders cash consideration totalling $3 million at the end of three years, with at least $1 million in each of the next three years; and
    - incur expenditures on the mineral property interests of Entity B of $4.5 million at the end of three years, with a minimum of at least $1.5 million incurred in each year.
- Entity A has determined it is probable that it will acquire the mineral property interest in the future or that economic benefits could be derived from this option in some other way (e.g., it could sell the option to a third party).
- Under the earn-in agreement, Entity A acquires either 100 per cent of Entity B in three years or 0 per cent if it does not meet all of the payment requirements. There are no other outstanding conditions to complete the acquisition.
- As part of the earn-in agreement, Entity B grants Entity A all necessary approvals to access the mineral property and to carry out activities outlined in the agreement.
- Entity A's accounting policy on E&E expenditures is to capitalize costs associated with the acquisition of the rights to explore and to expense exploration costs. Entity B's accounting policy is to capitalize all E&E expenditures.

Issue 1: How should Entity A account for the cash payments and earn-in expenditures incurred, prior to obtaining control of Entity B?

View 1A – Entity A should capitalize the costs as part of its E&E assets, consistent with its policy to capitalize acquisition costs under IFRS 6 Exploration for and Evaluation of Mineral Resources

- Proponents of this view think that the substance of the transaction is that Entity A has entered into an agreement to acquire the mineral property interest directly. Therefore, any expenditures

incurred during the earn-in period should be accounted for as costs to acquire the rights to explore.

- Entity A's accounting policy is to capitalize the costs to acquire a mineral property interest. Therefore, Entity A capitalizes the cash payments and earn-in expenditures incurred prior to obtaining control of Entity B.
- In assessing the asset for indicators of impairment, Entity A would apply paragraph 20 of IFRS 6, not paragraphs 8-17 of IAS 36 *Impairment of Assets*.

View 1B – Entity A should record the expenditures incurred during the earn-in period as a financial instrument

- Proponents of this view indicate that the legal rights to explore a specific area are held by Entity B until Entity A satisfies the earn-in requirements. Therefore, the earn-in expenditures prior to acquisition relate to the contractual right to acquire the outstanding shares of an entity, and not a mineral interest.
- The application guidance in IAS 32 indicates that financial instruments include derivative financial instruments, such as futures and forwards. Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks in an underlying primary financial instrument. Therefore, Entity A's option to acquire Entity B might be classified as a derivative.
- If the option is classified as a derivative, IFRS 9 would require Entity A to measure it both initially and subsequently at its fair value. That is because the contractual terms of the financial asset do not give rise on specified dates to cash flows that are solely payments of principal and interest.
- The fair value of the earn-in option agreement is not reliably measurable, and there is a wide range of possible fair value measurements. Therefore, cost may be the best estimate of fair value within that range.
- Since Entity B's only asset is the mineral property interest, it would be reasonable to apply the optional test to identify concentration of fair value in paragraphs B7A-B7C of IFRS 3 *Business Combinations* to conclude that Entity B does not meet the definition of a business. Therefore, once Entity A owns 100 per cent of Entity B, Entity A would derecognize the financial asset and recognize the net assets of Entity B. The fair value of Entity B's assets acquired would be the same as the fair value of the financial asset derecognized, and no gain or loss would be recognized by Entity A.
- If, during the earn-in period, Entity A determines that exercising the option is no longer probable, the financial asset's fair value may be nil. Entity A would consider whether derecognizing the financial asset is appropriate under IFRS 9. Derecognition would be inappropriate prior to obtaining ownership of Entity B or the contractual rights relating to the earn-in option agreement expire (i.e., at the end of three years). Derecognition would be appropriate if Entity A sells the earn-in option agreement to a third party.

View 1C – Entity A should record the expenditures incurred and payments made to the shareholders of Entity B for the mineral property interest as an acquisition-specific intangible asset

- Proponents of this view think the substance of the transaction is that Entity A has entered into an agreement to acquire the mineral property interest directly, and that this may be considered a contract to buy a non-financial item. Furthermore, Entity A intends to acquire the mineral property interest as part of its regular business model. Therefore, IFRS 9 would not apply because this standard does not apply to "contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements" (see paragraph 2.4 of IFRS 9). This is commonly referred to as the "own-use" exemption.
- Since Entity A determined that it is probable the acquisition of the mineral property interest will occur, the payments made to acquire Entity B and the expenditures incurred on the mineral property interest represent the costs required to acquire Entity B. Paragraph 12 in the Basis for Conclusions of IFRS 6 indicates that pre-acquisition expenditures related to the acquisition of an intangible asset might be recognized as an intangible asset in accordance with IAS 38. Once Entity A acquires 100 per cent of Entity B, it would derecognize the intangible asset and recognize Entity B's net assets.
- During the earn-in period, Entity A would apply IAS 36 to determine whether the intangible asset is impaired. In doing so, Entity A would consider whether any of the indicators of impairment outlined in paragraphs 8-17 of IAS 36 are present. If Entity A determines that exercising the option is no longer probable, the asset would be derecognized as no future economic benefits would be expected to be derived.

View 1D – Accounting policy choice

- Proponents of this view hold that IFRS Accounting Standards do not specifically consider this issue, and therefore, Entity A can make an accounting policy choice.

The Group's Discussion

Several Group members indicated that Entity A should first assess whether it has obtained control of Entity B upon entering into the agreement. One Group member shared that paragraph 9 of IFRS 3 states, "An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date," and, "the acquirer might obtain control on a date that is either earlier or later than the closing date." In this fact pattern, Entity A might have obtained control of Entity B upon entering into the agreement because Entity B granted Entity A all necessary approvals to access the mineral property and to carry out activities outlined in the agreement. One Group member commented that Entity A might control Entity B because Entity A has entered into a call option to purchase 100 per cent of Entity B's shares. If Entity A has the ability to exercise these options immediately and obtain the full benefit of ownership of Entity B's shares, it might be viewed that Entity A controls Entity B.

Assuming Entity A has not obtained control of Entity B upon entering into the agreement, the Group agreed with the analysis of the accounting options discussed above. Several Group members agreed with View 1B because Entity A has entered into an option agreement to acquire the shares of Entity B. Entity A can choose to exercise this option by making the specified payments to Entity B's shareholders and incurring the required E&E expenditures, or it could sell the option to a third

party. This type of arrangement could be considered a derivative financial instrument, in the scope of IFRS 9. Some Group members noted that they agree with View 1A because Entity A has in substance entered into an agreement to acquire the mineral property interest. Several Group members indicated that each of the views presented have merit, and therefore, Entity A may make an accounting policy choice in accordance with IAS 8.

Issue 2: What accompanying disclosures are required?

Analysis

- Depending on the conclusion for Issue 1, an entity would be required to apply the specific disclosure requirements set out in IFRS 6, IFRS 9 or IAS 38. In addition, Entity A might need to include additional disclosures required by IAS 1
- *Presentation of Financial Statements*, if material. This standard indicates that an entity is required to consider providing additional disclosures when compliance with the specific requirements in IFRS Accounting Standards is insufficient. These additional disclosures are required to enable financial statement users to better understand the impact of particular transactions, other events and/or conditions on the company's financial position and financial performance. For example, even if Entity A accounts for this option agreement as a financial instrument or an intangible asset, it might consider including the disclosures required by paragraph 25 of IFRS 6 because the underlying assets are E&E assets.
- If Entity A applies the disclosure requirement in paragraph 25 of IFRS 6, it may include the option to acquire Entity B and its mineral interests in a separate note, which might include a continuity schedule relating to the mineral interest. While Entity A does not have control of Entity B's legal right to the mineral property interest, the disclosure in this note must be sufficiently clear to separate the earn-in option agreement from Entity A's other E&E assets.
- If material, Entity A would also disclose accounting policy information and the judgments management has made in the process of applying its accounting policies related to the earn-in option agreement.

The Group's Discussion

The Group agreed with the analysis. Group members agreed that, depending on the conclusion reached in Issue 1, an entity would be required to apply the specific disclosure requirements set out in IFRS 6, IFRS 9 or IAS 38. One Group member indicated that disclosure requirements in several standards might be relevant to financial statement users, and that an entity should consider all the facts and circumstances of the arrangement and their user needs when determining what additional information to disclose. One Group member indicated that the disclosure requirements in IFRS 6 might not be required if Entity A determines that the earn-in expenditures are accounted for under IFRS 9. They noted that Entity A might consider applying the disclosure requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* if they determine that the future earn-in expenditures represent a contingent liability.

Issue 3: What are the implications if Entity A's earn-in of Entity B is achieved in stages?

Fact pattern for Issue 3

- The same fact pattern as Issues 1 and 2, except the earn-in option agreement allows Entity A to acquire 80 per cent of Entity B in the following stages:
    - Entity A acquires 40 per cent of the common shares of Entity B after making cumulative cash payments of $2 million to Entity B's shareholders and paying $3 million of expenditures on the mineral property interests by the end of Year 2.
    - Entity A acquires 80 per cent of the common shares of Entity B after making cumulative cash payments of $3 million to Entity B's shareholders and paying $4.5 million of expenditures on the mineral property interests by the end of Year 3.
- Entity A meets the conditions to acquire 40 per cent of Entity B by the end of Year 2 and another 40 per cent by the end of Year 3.

Years 1 and 2

- During Years 1 and 2, Entity A would apply the same accounting policy discussed in Issue 1 because it does not yet have an interest in Entity B.

After two years

- Paragraph 5 of IAS 28 *Investments in Associates and Joint Ventures* indicates that significant influence is presumed if an entity holds 20 per cent or more of the voting power of an investee unless it can be demonstrated that this is not the case. Since Entity A obtains 40 per cent of the common shares of Entity B at the end of Year 2, this presumption applies.
- Entity A might consider some additional factors that could indicate significant influence over Entity B exists. For example, the presence of material transactions between Entity A and Entity B and the provision of essential technical information from Entity A to Entity B might support this presumption. However, Entity A might also consider the amount of discretion it has over the expenditures incurred on the mineral property interest as part of this analysis.
- Entity A might also assess at the end of Year 2 whether it has met the conditions of control of Entity B outlined in paragraphs 5-18 of IFRS 10 *Consolidated Financial Statements*.
- If significant influence exists, Entity A would apply the equity method and initially recognize its investment in Entity B at cost. Entity A would then recognize its share of Entity B's profit or loss as an increase or decrease in the carrying amount of the investment. In applying the equity method, Entity A would also need to ensure that Entity B has prepared its financial statements using uniform accounting policies for like transactions and events in similar circumstances as those of Entity A.
- Entity A might also consider whether the specific terms and conditions of the earn-in option agreement include provisions for contractually agreed sharing of control of an arrangement. This exists when decisions about relevant activities require the unanimous consent of the parties sharing control (i.e., joint control with another party). Depending on the rights and obligations of the parties to the arrangement, Entity A would need to determine whether the arrangement is a joint operation or a joint venture.

After three years

- Upon acquiring 80 per cent of Entity B, Entity A would assess whether it has acquired control of Entity B. Assuming it has, Entity A discontinues applying the equity method and Entity B becomes a subsidiary. While IFRS 3 does not apply to the acquisition of an asset or a group of assets that does not constitute a business, Entity A may consider applying IFRS 3 by analogy. If so, Entity A would account for this acquisition achieved in stages and remeasure its previously held equity interest in Entity B at its acquisition date fair value. Entity A would recognize the resulting gain or loss, if any, in profit or loss.
- IFRS 10 and IFRS 3 do not address the initial measurement of non-controlling interest, where the acquired entity is not a business. Therefore, upon acquisition of control, Entity A may recognize the asset acquired at fair value (i.e., at 100 per cent), and recognize the non-controlling interest of Entity B at fair value. In this case, Entity A gave consideration of $7.5 million to acquire 80 per cent of Entity B. Entity A would, therefore, recognize the asset acquired at its fair value which, for this discussion, is assumed to be $9,375,000, and the non-controlling interest recognized would be $1,875,000 (20 per cent of $9,375,000).

The Group's Discussion

One Group member commented that Entity A should assess whether it has obtained control of Entity B upon entering into the agreement for the same reasons outlined in the discussion of Issue 1. Another Group member indicated that Entity A should assess whether the terms and conditions of the agreement are such that it has obtained joint control upon entering into the agreement. Assuming Entity A has not obtained control or joint control of Entity B upon entering into the agreement, the Group agreed with the analysis of the accounting options discussed above.

Overall, the Group's discussion raised awareness of how an entity accounts for earn-in expenditures prior to the acquisition of a mining interest. No further actions were recommended to the AcSB.