BDO NATURAL RESOURCES TECHNICAL UPDATE

APPLICATION OF IFRS 16 TO MINERS

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IFRS 16 Leases is the new lease accounting standard that is likely to cause significant changes to miners' financial statements. This standard requires miners to recognise most leases on their balance sheet as lease liabilities with a corresponding right of use asset. The profit or loss recognition pattern will change as interest and depreciation expenses are recognised separately in the profit or loss.

As the current accounting for operating leases and service contracts is similar, miners may not have always focused on determining whether an arrangement was a lease or a service contract.

Miners often have the following contracts which now could be within the scope of IFRS 16:

- Property and asset rental agreements
- Mining services and construction contracts
- Power supply contracts
- Transportation and shipping agreements
- Contracts for mine camps
- Service agreements which include the use of assets

Leases to explore for, or use, natural resources are not within the scope of IFRS 16 (refer IFRS 16.3).

FINANCIAL METRICS

The adoption of IFRS 16 eliminates nearly all off balance sheet accounting for lessees and redefines many commonly used financial metrics such as the gearing ratio and EBITDA. Miners need to consider the impact that changes in financial metrics have on debt covenants and key performance indicators including those affecting employee bonus and share plans.

IS THERE A LEASED ASSET?

A lease is defined in IFRS 16 Appendix A as:

"A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration".

In order for there to be a leased asset, all of the following criteria must be met:

- There is an identified asset,
- The miner obtains substantially all of the economic benefits of the asset, and
- The miner has the right to direct the use of the asset, making the 'how and for what purpose' decisions in relation to the use of the asset.

IDENTIFIED ASSET

An identified asset can be either implicitly or explicitly specified in a contract and can be a physically distinct portion of a larger asset (e.g. floor of a building).

For example, a remote mine site power supply agreement will include an identified asset, being the power plant constructed next to the mine, even if the power plant is not explicitly identified in the power supply contract.

Substitution Rights

If the supplier has substantive substitution rights, then the asset is not an identified asset (IFRS 16.B14). A supplier's substitution right is substantive if the supplier:

- Has the practical ability to substitute the asset, and
- Would benefit economically from exercising its right to substitute the asset.

It may be difficult for miners to determine that a supplier would economically benefit from exercising substitution rights. Where a miner cannot readily determine whether a supplier has a substantive substitution right, they should presume that the substitution right is not substantive (IFRS 16.B19).

For example, substitution rights may be substantive in relation to fleets of vehicles where the supplier has a number of customers within close proximity and is able to use the vehicles on each mine site without changes to the configuration or load set of the vehicles.

Accordingly, the supplier would benefit economically from substituting the vehicles.

Examples of where a substitution right will not be substantive include:

- A supplier's obligation to substitute an asset for repairs and maintenance (IFRS 16.B18),
- The mine site is in a remote location making it uneconomic for the supplier to substitute assets,
- The asset is significantly customised for the miner's conditions,
- Moving the asset incurs significant mobilisation and demobilisation costs to the supplier.

OBTAINING SUBSTANTIALLY ALL OF THE ECONOMIC BENEFITS

The next element in determining whether a customer controls the use of an identified asset is whether the customer has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use.
This is demonstrated by having exclusive use of the asset or by sub-leasing the asset.

The assessment as to whether a contract contains a lease should not consider economic benefits relating to ownership of an asset (IFRS 16.BC118).

Obtaining Economic Benefits - Example

A miner enters into a contract with a supplier to purchase 100% of the energy produced by a solar power plant. The supplier received tax incentives for building the facility as it produces clean, renewable energy.

The contract transfers to the miner the right to obtain substantially all of the economic benefits from use of the underlying asset because the miner has exclusive use of the primary product of the plant (i.e. the electricity).

While the supplier realises benefits in the form of tax incentives, these are based on the ownership of the asset from a legal perspective and not its use.

Therefore, the tax incentives are disregarded in determining who obtains substantially all of the economic benefits during the contract term.

RIGHT TO DIRECT USE OF THE ASSET

Determining who has the right to direct the use of the asset is focused on who controls the use of the asset during the term of the contract. IFRS 16.B24 provides:

A customer has the right to direct the use of an identified asset throughout the period of use only if either:

a) The customer has the right to direct how and for what purpose the asset is used throughout the period of use, or

b) The relevant decisions about how and for what purpose the asset is used are predetermined and:

(i) The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions, or

(ii) The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Considerable analysis and judgement is required in determining the significance of the different how and for what purpose decisions. This involves an analysis of the critical terms and conditions that indicate control of the asset.

This analysis can be difficult, particularly if the miner and the supplier each make some of the 'how and for what purpose' decisions. If some decisions have greater significance than others, then the party that makes the more significant decisions will be considered to direct the right to use the asset.

Right to Direct Use of the Asset - Example

Mining Company ABC enters into a contract mining contract with Supplier X. Under the terms of the agreement, Mining Company ABC develops the mine plan, providing quarterly updates to the plan.

The mine manager, employed by Mining Company ABC, has the right to dictate the different areas to be mined on a day to day basis by the staff employed by Supplier X. Supplier X has a fleet of vehicles and equipment which it uses in performing the contract mining services for Mining Company ABC.

As Mining Company ABC determines the mine plan and has the right to dictate the different areas to be mined on a day to day basis, Mining Company ABC has the right to direct the use of assets used by Supplier X in providing contract mining services to Mining Company ABC.

LEASE AND SERVICE COMPONENTS

Many contracts entered into by miners contain lease and non-lease (service) components. There is a policy election within IFRS 16 whereby companies may elect to treat the whole contract as a lease or separately account for the lease and non-lease components.

Identifying the components and allocating stand-alone pricing to the components is likely to require considerable judgement and estimation. Miners may not have the information to separate out the lease and non-lease components.

In determining whether there are leases within service contracts, considerable judgement will be required in determining:

- Are there specified assets? If yes, there may be a lease
- Does the supplier have substantive substitution rights in relation to the specified assets? If no, there may be a lease
- Does the miner have the right to direct the use of the asset? If yes, in conjunction with there being a specified asset and the supplier not having substantive substitution rights, there will be a lease embedded in the service contract.

Once it has been determined that there is a lease within a service contract, considerable estimation and judgement is required in measuring the right of use asset and lease liability.

These include:

- Determining the stand-alone selling price of performance obligations within the contract, considering the different goods and services provided under the contract which include the right of use of assets,
- Determining the interest rate implicit in the lease,
- Calculating the right of use asset and lease liability, and
- Accounting for modifications to the contract.

In a contract mining agreement, the mining company may be provided with:

- The right to use specified assets for which the contract mining company has substantive substitution rights (e.g. a fleet of haul trucks), these are not leased asset and form part of the contract mining service,
- The right to use a specified asset for which the contract mining company does not have substantive substitution rights (e.g. a crushing plant that has been configured to the miner's ore and required significant mobilisation and demobilisation costs to be incurred), this is a leased asset embedded in the contract mining contract,
- Staff to perform the contract mining work, this is a non-lease component of the contract.

Determining the standalone selling prices of the above components (and many others) within a contract mining agreement, considerable judgement is required to be made by the miner.

Some miners may find it useful to adopt the practical expedient in IFRS 16.15 which states:

"As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component…"

However, adoption of this practical expedient is likely to result in a significant gross up of leased assets, thus reducing the comparability of a miner's financial statements.

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