BDO NATURAL RESOURCES TECHNICAL UPDATE

APPLICATION OF IFRS 15 TO MINERS

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It is reasonable to say that the mining sector is far less impacted by IFRS 15 "Revenue from Contracts with Customers" than sectors such as telecoms, software, construction and indeed mining service companies.

However, it is wrong to assume that miners are not impacted by this new standard and mining companies need to consider potential impact areas.

To analyse IFRS 15, it is necessary to consider whether the contract is within the scope of the standard and the five key steps in application of the standard.

SCOPE - IS THE CONTRACT WITH A CUSTOMER?

The standard applies to income earned from contracts with customers. Some sales of commodities may be outside the scope of the standard if the counterparty does not meet the definition of a customer as defined in the standard.

IFRS 15 defines a customer as:

"a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration."

Arrangements where the parties are participating in an activity together and share the risks and benefits of that activity are not considered contracts with customers; these are participation arrangements.

All of the relationships in a partnership or collaboration agreement must be understood to identify whether all or a portion of the agreement is a contract with a customer or is outside the scope of IFRS 15.

Determining whether the contract is even within the scope of the standard may be a challenge in relation to the following:

- Accounting for off-take arrangements
- Accounting for streaming
- Production sharing arrangements
- Royalty payments and other payments to mineral owners
- Forward-selling contracts to finance development
- Product exchanges.

STEP 1: IDENTIFY THE CONTRACT

Most of the issues in application of IFRS 15 to miners are where miners enter into long-term supply and off-take arrangements with customers rather than where the commodity is sold on the spot market.

Linking of Contracts

IFRS 15 requires miners to link contracts if they were entered into at the same time and were linked economically. In some instances, a miner may enter into a number of agreements or a series of agreements with the same customer. In these situations, they will have to determine whether the agreements should be linked, in which case the pricing of the combined contracts will have to be allocated across the distinct performance obligations (being the promise to deliver a quantity of a commodity). Processes and systems will have to be put in place to identify and account for linked contracts.

Contract Modifications

By their nature, long-term supply and offtake agreements spread over a period of time. This significantly increases the likelihood that these contracts are altered over the contract term. For example, change in contracted quantity, pricing, grade or term will give rise to a contract modification. Contract modifications are accounted for as either a separate contract or as part of the existing contract, depending upon the nature of the modification. Systems and processes will need to identify such modifications and to record revenues in accordance with IFRS 15.

STEP 2: IDENTIFY THE PERFORMANCE OBLIGATION

In its simplest form, miners have a single performance obligation, being the promise to supply a customer with a particular mineral.

In long-term supply contracts this may be a series of distinct performance obligations, being a series of deliveries. However, there are certain situations where the miner provides additional services such as:

- Shipping
- Insurance
- Storage.

Careful analysis will be required as to what services are provided and as to whether these services are performed at the same time as ownership of the commodity is transferred to the customer. If they are not provided at the same time the recognition of revenue relating to those services will need to be deferred or accelerated.

It is important to determine whether the mining company is acting as a principal or as an agent in providing additional services. Miners acting as agents do not recognise revenue for any amounts received from a customer to be paid to the principal.

Some sales contracts give customers the option to purchase additional goods priced at a discount.
The option is only a separate performance obligation if it provides a material right to the customer.

STEP 3: DETERMINE THE TRANSACTION PRICE

Step 3 of IFRS 15 introduces as number of complex issues for miners including:

- Prepaid off-take contracts
- Streaming
- Variable pricing.

Prepaid Offtake Contracts

In a number of situations, the miner may enter into a supply/financing arrangement whereby it receives cash from the customer well in advance of supplying the commodity.
Such contracts are usually drafted to satisfy the "own use exemption" of IFRS 9 "Financial Instruments", whereby the contract will be satisfied by delivery of the miner's output.
The 'customer' may be a financier that receives repayment via the delivery of physical product.

Under existing practice, a prepaid off-take contract would typically not record any financing costs. For example, Miner X enters into a "gold loan" to supply 1,000oz of gold over the next four years at $1,000 per oz., with the $1,000 per oz. being at a discount to the current forward / spot prices. Such a transaction would initially be recorded as:

Dr Cash $1,000,000

Cr Deferred revenue $1,000,000

Revenue is recognised at $1,000 per oz. as the gold is delivered. Applying IFRS 15 requires the miner to account for the financing arrangement built into the contract and, therefore, the miner will effectively gross up revenue and recognise a financing cost.

This will result in increased revenue, being much closer to the market price of gold, and a financing charge. If the miner were constructing a qualifying asset, the financing charge would be capitalised in the cost of that asset..

Streaming

Streaming arrangements are a form of alternative finance in the natural resources sector, where a miner will stream some or all secondary minerals to a customer. For example, a gold miner sells 50% of the silver it produces in return for an upfront fee and a set price per ounce for silver actually delivered to the streamer, that is, the customer. The arrangement typically involves the streamer having the right to a minimum quantity of silver, which if not delivered will result in the repayment of part of the initial upfront payment. However the amount of silver delivered to the customer is not limited, with the investor taking some or all of the exploration upside for silver.

Streaming arrangements cause two practical issues when applying Step 3 of IFRS 15:

- Firstly, there is an embedded finance charge that will have to be grossed up in the same way as the prepaid offtakes; and
- Secondly there are practical issues applying the reversal constraint to such a transaction. Revenue can only be recognised to the extent it is "highly probable" that it will not reverse. Miners will have to be very conservative in estimating the quantity of commodity that will be supplied under the streaming contract, which is likely to initially see less revenue being recognised per ounce sold than under current practice.

Variable Pricing

A much debated area of practical application is where the ultimate pricing of the commodity sold is determined at a point in time after the product is supplied to the customer, typically being the commodity price when the ore or concentrate is actually smelted.

This type of contingent pricing arrangement typically has four components giving rise to uncertainty as to the amount the miner will ultimately receive:

- Future commodity price
- Quantity and quality of commodity provided (for example, moisture content)
- Quantity of valuable bi-products
- Quantity of contaminants.

Whilst it can be argued that movements in the commodity price are not connected with whether the miner has fulfilled its performance obligation and are therefore not subject to the reversal constraint, the variability as to the quality and quantity of the ore / concentrate provided are directly related to the miner's performance and will therefore be subject to the reversal constraint.

STEP 4: ALLOCATE CONSIDERATION TO PERFORMANCE OBLIGATIONS

IFRS 15 requires a miner to account for each distinct good or service as a separate performance obligations. There are situations where a commodity is sold together with services (for example: storage, shipping and insurance) and accordingly the revenue arising under the contract is required to be allocated to the separate performance obligations in accordance with the stand alone selling prices of those services.

STEP 5: RECOGNISE REVENUE

Revenue is recognised when performance obligations are satisfied; normally this is when legal title to the product passes to the customer as this is what indicates that control has passed.

It is important to understand the terms of trade in order to determine when control of the goods has passed to the customer. Common terms of trade and the timing of income recognition for miners are:

- CIF – the miner has to pay the costs of freight and insurance associated with the shipping. If risk and title only pass to the customer on unloading at the destination port, then revenue is recognised at the date of unloading
- FOB – control of the goods transfers to the customer at the moment that the product passes the ship's rail, as a result, revenue is recognised by the miner upon delivery to the carrier
- Mine gate – control of the goods transfers to the customer at the moment that the product passes the mine gate, as a result, revenue is recognised by the miner upon the product passing the mine gate.

A miner may enter into a bill and hold arrangement with a customer if a customer requests delayed shipment because of limited storage space or delays in production. IFRS 15 requires an analysis to determine if the miner has satisfied its obligation to transfer the product by determining whether the customer has control of the product. Factors to consider are:

- The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement)
- The product must be identified separately as belonging to the customer
- The product currently must be ready for physical transfer to the customer, and
- The entity cannot have the ability to use the product or direct it to another customer.

FOR MORE INFORMATION ON THE APPLICATION OF IFRS TO MINERS, CONTACT OUR IFRS ADVISORY EXPERTS:

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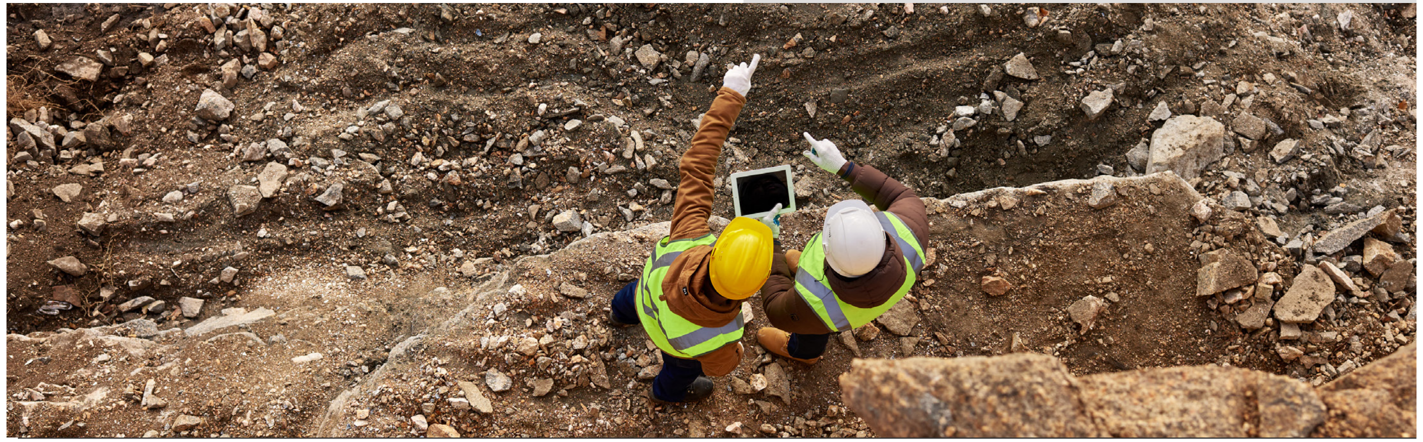

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