VIEWPOINTS:

Applying IFRS® Standards in the Mining Industry

IFRS 16 *LEASES*—KEY RECOGNITION CONSIDERATIONS FOR THE MINING INDUSTRY

DECEMBER 2018

Mining Industry Task Force on IFRS Standards

International Financial Reporting Standards (IFRS®) create unique challenges for mineral resource companies. Financial reporting in the sector is atypical due to significant differences in characteristics between mineral resource companies and other types of companies. The Chartered Professional Accountants of Canada (CPA Canada) and the Prospectors & Developers Association of Canada (PDAC) created the Mining Industry Task Force on IFRS Standards (Task Force) to share views on IFRS application issues of relevance to mineral resource companies. The views of the Task Force are provided in a series of papers, entitled Viewpoints, available through free download. These Viewpoints are of particular interest to chief financial officers, controllers and auditors.

Background

IFRS 16, *Leases* is the new standard that sets out the principles for the recognition, measurement, presentation and disclosure of leases.

This *Viewpoint* considers some key lease recognition issues in contractual arrangements common to the mining industry and how the accounting for such agreements may be affected by IFRS 16. It focuses on the recognition of leases from a lessee perspective and does not consider transition, measurement and subsequent accounting for leases, lessor accounting issues or the new disclosure requirements of IFRS 16. This *Viewpoint* is not intended to be exhaustive and there are a number of other considerations that financial statement preparers will need to take into account when evaluating the impact of IFRS 16 on their financial statements.

CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

PROSPECTORS & DEVELOPERS ASSOCIATION OF CANADA

IFRS 16 introduces a single-lessee accounting model and requires a lessee to recognize assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value (see below).

IFRS 16 requires lessees to recognize right-of-use assets and lease obligations for all leases, except:

- leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources
- leases for biological assets (see IAS 41, *Agriculture*)
- service concession arrangements (see IFRIC 12, *Service Concession Arrangements*)
- licences for intellectual property (see IFRS 15, *Revenue from Contracts with Customers*)
- rights held under licensing agreements such as films, videos, plays, books, patents and copyrights (see IAS 38, *Intangible Assets*).

A contract is, or contains, a lease when the contract conveys the right to control the use of an identified asset that is not owned by the entity for a period of time in exchange for consideration. Control exists when the lessee has both the right to direct the use of the asset and obtains substantially all the economic benefits during the period of use. IFRS 16 eliminates the criteria for classification of leases as operating or finance leases in the prior standard (i.e., IAS 17, *Leases*). As a result, the evaluation of whether a contract contains a lease frequently determines whether the arrangement is accounted for on-balance sheet as a lease or potentially off-balance sheet as a service arrangement.

The right-of-use assets (i.e., leased assets) are initially measured at cost, which comprises the initial lease liability adjusted for any lease payments made at or before the commencement date, plus any initial direct costs and any estimated costs to dismantle and remove the underlying asset or to restore the underlying asset or the site on which it is located, less any lease incentives received. The right-of-use asset is subsequently depreciated typically over the lease term and generally on a straight-line basis. Lease liabilities are initially measured at the present value of the future lease payments and are amortized over the lease term using the effective interest method, resulting in interest expense. As such, subsequent to initial recognition, the lease asset and lease obligation will not match. This is generally consistent with measurement of finance leases under IAS 17.

Issue

Certain contractual arrangements common to the mining industry will likely be impacted by IFRS 16. Key lease recognition issues in the mining industry include:

- mineral leases and surface-land contracts
- short-term leases and low-value items (or low-value leases)
- identifying leases embedded in mining services contracts, including drilling and similar contracts
- lease and non-lease components of contracts.

Viewpoints

Mineral Leases and Surface-Land Contracts

Consistent with IAS 17, leases to explore for or use minerals and similar non-regenerative resources are not within the scope of IFRS 16. Mining entities will need to apply judgment to determine how to interpret and how broadly to apply this scope exclusion.

IFRS 16 appears to be unclear on whether the scope exclusion applies broadly to other leases that relate to, or are directly or indirectly part of, the process of exploring for or using, those resources. For example, mining entities may lease or pay for easements to surface land to provide exclusive access to areas of exploration and exploitations such as roadways or rights of access or to place conveyers or pipelines. The wording of the exclusion specifies that it applies to "leases to explore for or use minerals" and, in the view of the Task Force, this exclusion applies across all phases of an entity's mining activity. Judgment will be required to determine specific leases which qualify for the scope exclusion.

Subsurface mineral rights are generally owned by the land owners, such as federal, state or provincial governments. In addition, surface-land leases are commonly obtained from land owners for access to the subsurface.

Landowner mineral leases for mining rights are specifically exempt from IFRS 16; however, surface-land leases and similar rights-of-way contracts are not specifically exempt. Judgment must be applied to determine whether the surface-land lease should be accounted for in a manner consistent with the related mineral leases. In making this determination, questions to consider, include but are not limited to:

- Does the surface-land lease specifically cover both surface-land and subsurface mineral rights?
- Does the surface-land lease provide any economic benefit other than allowing access to explore for or use the mineral rights?
- Is there legislation that compels the surface-land owners to grant access to the mineral rights?

Additionally, for land easements and similar contracts, judgment will be required to determine if the mining entity obtains substantially all of the economic benefits from use of the land subject to the easement. In many cases, rights to use roadways or place certain infrastructure on land may not give the mining entity the ability to obtain substantially all of the economic benefit of the associated land, which may have ongoing alternative uses for the landowner. Based on the specific facts and circumstances, the contract would probably not be considered a lease under IFRS 16.

Based on the views of the Task Force, the scope exemption relates solely to the rights to explore for or use mineral resources and would not apply to leases for mining equipment, machinery or similar items that may be used in the exploration or exploitation of minerals.

Short-Term Leases and Low-Value Items (or Low-Value Leases)

IFRS 16 applies to most leases except those specifically excluded (see above). IFRS 16 includes recognition exemptions available to lessees for short-term leases and leases of low-value items, which removes those leases that qualify for these exemptions from the recognition and measurement requirements of the standard. Judgment will be required to conclude that the exemptions apply to individual leases.

A short-term lease is defined as a "lease that, at the commencement date, has a lease term of 12 months or less." While this is a clear definition, companies will nevertheless have to assess the effect of extension and termination options included in a lease to determine if it qualifies as a short-term lease. Additionally, regardless of the lease term, a lease that contains a purchase option cannot be classified as a short-term lease.

It is important to note that on transition, IFRS 16 includes a practical expedient which allows lessees to designate leases that will terminate within 12 months of the initial adoption date (January 1, 2019) as short-term leases irrespective of the full term of the lease or contract. For example, a mining entity may have a lease contract with a three-year term from July 1, 2016, that terminates on June 30, 2019, for which, through applying this practical expedient, the lease may be deemed a short-term lease and, therefore, would be excluded from the recognition requirements of the standard.

Lessees may choose not to apply IFRS 16 to contracts for assets of low value. This exemption is intended as a practical expedient when accounting for low-value items. It is noted that this exemption is not available for leases of assets highly dependent on, or highly interrelated with, other assets which, when used as intended, would not be considered low-value assets.

While IFRS 16 does not specify a value threshold, the Basis for Conclusions suggests that a threshold of US$5,000 per asset when new was considered for the exemption. No specific dollar value was specified in IFRS 16 due to the potential effects of foreign exchange and inflation; however, this dollar threshold should be considered when applying this optional exemption. In practice, determining whether items are of "low value" may be challenging, given that the guidance is limited. Preparers may put more focus on the nature of the underlying asset. For instance, the Basis for Conclusion for IFRS 16 cites tablets, personal computers, office furniture and telephones as examples. This will be an area of judgment for mining entities; financial statement preparers may consider the general principles of materiality in applying IFRS 16.

The election for exemption of short-term leases must be made by class of underlying asset, whereas the election for exemption of leases for which the underlying asset is of low value can be made on a lease-by-lease basis. Though short-term leases and low-value leases are exempt from the recognition requirements of IFRS 16, the standard requires disclosure of the expense associated with short-term leases (excluding leases of one month or less) and low-value leases. Accordingly, financial statement preparers will need to identify and track such leases to facilitate financial statement disclosures.

Identifying Leases Embedded in Mining Services Contracts, Including Drilling and Similar Contracts

A contract contains a lease when the contract conveys the right to direct the use of an identified asset and obtain substantially all the economic benefit from the asset in exchange for consideration for the period of use. Many contracts which mining entities might previously have considered to be service contracts may include leases of equipment within the contract, for instance, when there is an identified asset(s) explicitly or implicitly included in the contract and the mining entity has the ability to control that asset(s) during the contract term. Accordingly, financial statement preparers should carefully review existing and new mining-service contracts to determine if they contain a lease which is required to be recognized under IFRS 16.

Identified asset

Paragraph B13 of the Basis for Conclusion for IFRS 16 states that "an asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer." For instance, if a serial or identification number of the asset is included in the contract, the asset is explicitly specified. If the supplier, however, has the substantive right to substitute the asset for another asset, the asset is not an identified asset and, therefore, not a lease. A supplier's substitution right is "substantive" if the supplier has the practical ability to substitute the asset throughout the period of use and would benefit economically from exercising its right to substitute the asset. For example, a mining entity may contract a third party to transport concentrates by truck or rail. If the contract allows the transportation company to use any truck or railcar to ship production to a sales point, or the transportation company has a substantive substitution right in the contract, it is most likely not an identified asset and, therefore, probably not a lease.

Assets do not need to be explicitly specified in the contract to qualify as an identified asset. The key test is whether the asset is specified at the time when it is made available to the customer. For example, a mining entity may enter into a contract for drilling services in an underground mine for a two-year period. The contract specifies that the driller has to provide an appropriate drill rig to complete the services but does not specify the exact drill rig or a specific type of drill rig. The driller may have a number of potential drill rigs available to fulfill the contract, any of which could be transported to the site. Once a specific drill rig is transported to the site and brought underground, from a practical perspective, only that drill rig can be used to fulfill the contract. Though the contract did not explicitly identify the asset to be used, the individual drill rig may be considered to be implicitly specified as an identified asset when it is made available to the mining entity and, therefore, may be considered to be a lease under IFRS 16.

The capacity portion of an asset may be an identified asset if it is physically distinct. For example, office space that consists of a specific floor or a specific part of a floor of an office building is physically distinct. As such, each specific floor or specific part of a floor may be considered to be an identified asset.

A capacity portion of an asset that is not physically distinct is not an identified asset. For example, MineCo enters into an arrangement with Warehouse Co. for the right to store copper cathode at Warehouse Co.'s specified warehouse. The warehouse is an open concept design without separate, physically distinct sections. At inception of the contract, MineCo has rights which permit it to use up to 30% of the capacity of the warehouse throughout the term of the contract. Warehouse Co. can use the other 70% of the warehouse as it deems appropriate. In this example, MineCo most likely does not have an identified asset because it only has rights to 30% of the warehouse's capacity and that capacity portion is neither physically distinct from the remainder of the warehouse nor is it "substantially all" of the warehouse.

Key considerations in determining whether or not the contract includes an identified asset include:

- Is an asset or type of asset specifically identified in the contract?
- Will the supplier be required to provide certain assets for the duration of the contract in order to fulfill the contract?
- Does the supplier have a substantive substitution right?[1]
- Once an asset is made available to the mining entity (i.e., brought to site), is substitution logistically feasible or economically beneficial?[2]

Control

Control of an asset requires both the right to obtain substantially all the economic benefits during the term and the right to direct the asset's use.

When considering the economic benefits, only those economic benefits obtained during the lease term are considered. If the lease term is only for a portion of the economic life of the asset, only that portion under contract is considered. For example, if a mining entity has exclusive rights to use a haul truck for two years, but the haul truck has a life of 10 years, the mining entity has the right to obtain substantially all the economic benefits for the two-year term and the contract likely contains a lease for those two years. The economic life outside the contract term is not relevant to the lease determination.

When determining control over the asset, the rights to direct how and for what purpose the asset is used throughout the period of use are considered. If the use of the asset, however, is predetermined and the customer either has the right to operate the asset or has designed the asset in such a way that predetermines its use, then the customer is most likely deemed to direct the use of the asset.

IFRS 16 includes examples of rights that, depending on the circumstances, grant the right to change how and for what purpose the asset is used within the defined scope of the customer's right of use. These include rights to change:

- the type of output produced by the asset (e.g., to decide whether to use a haul truck to move waste or ore)

1 The supplier having the ability or requirement to substitute an asset only for maintenance or repair is not considered to have a substantive substitution right.

2 The concept of "economically beneficial" is different when compared with IFRIC 4 *Determining Whether an Arrangement Contains a Lease*, which required that substitution be economically feasible. IFRS 16 has a higher threshold for substitution rights than the previous standard.

- when the output is produced (e.g., to decide when an item of machinery or a plant will be used)
- where the output is produced (e.g., to decide upon the destination of a truck or a railcar or to decide where an item of equipment is used)
- whether the output is produced and the quantity of that output (e.g., to decide whether to use the asset to produce from a mine and how much ore to produce).

Decisions limited to operating or maintaining the asset generally do not convey the right to use the asset.

For example, in the case of a drilling contract, where the customer has the right to decide the location of the drill rig and the targets to be drilled, and the operator is in charge of providing the drill rig and managing operations and maintenance, the Task Force is of the view that the customer's rights to determine the strategic use of the drill rig would typically result in the customer directing the use of the drill rig; however, making that assessment will require the mining entity to assess all the facts and circumstances, before coming to that conclusion.

Other indicators of the customer directing the use of a drill rig may include the customer's right to determine when to use or not to use the drill rig or pay the operator a "stand-by" fee when the drill rig is not in use. If the drilling operator cannot use the drill rig elsewhere (i.e., does not have a substantive substitution right), the stand-by fee would typically meet the definition of a lease as it is an in-substance fixed payment representing the minimum unavoidable commitment by the customer to the drilling operator. Stand-by commitments are generally expressed in a specific number of drilling days. If the committed number of drilling days could reasonably be used up in 12 months or less, the optional short-term exemption may be applied.

See Appendix for a flow chart illustrating whether a contract contains a lease.

Lease and Non-Lease Components of Contracts

In many cases, a contract may contain both a lease of an asset and a service being provided. A drilling contract generally contains both a drill rig and an operating crew. If the use of the drill rig is determined to be a lease, the portion of the contract pertaining to the drill rig must be separated from the service portion of the contract (i.e., the services of an operating crew), unless the practical expedient noted above is used. A portion of the contract cost must be allocated to the lease component based on the proportionate value of the lease and service components of the contract.[3]

Charges for administrative tasks and other costs (e.g., insurance costs) associated with the lease that do not transfer a good or service to the mining entity are not a separate component; they are, however, part of the consideration to be allocated to the lease and service components of the contract.

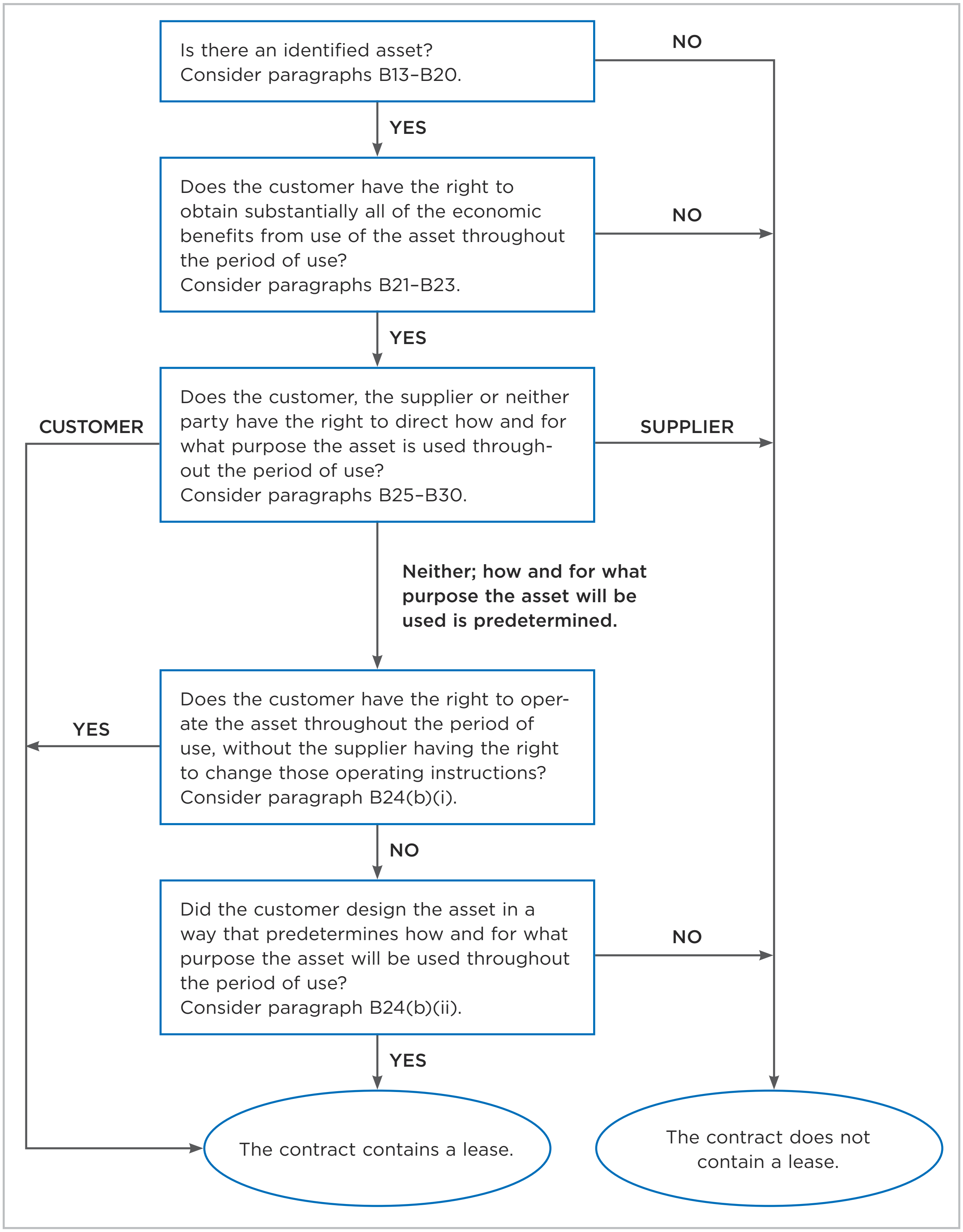
3 The value is based on the stand-alone price or a best estimate of the stand-alone price of the lease component.

IFRS 16 includes a practical expedient whereby a lessee can elect an accounting policy choice by class of underlying asset so as not to separate the lease and non-lease components. When this practical expedient is elected, the mining entity accounts for the entire contract as a lease. The Task Force notes that, to the extent there are fixed payments allocated to non-lease components, this practical expedient increases the right-of-use asset and associated lease liability that would be recognized on inception of a lease. As such, the application of this expedient could have a significant impact on a mining entity's balance sheet and key operating measures, including cash costs and EBITDA, and thus should be carefully considered by financial statement preparers before accounting policies are selected.

IFRS 16 requires disclosure of expenses relating to variable lease payments that are not included in the measurement of the lease liability. If a contract contains variable payments that relate to both lease and non-lease components, the same considerations as those discussed above will need to be considered in determining the lease and non-lease components and allocating the variable lease payments or electing to apply the practical expedient to treat the entire payment as a lease payment.

Appendix: Flowchart for Identifying a Lease Under IFRS 16

The following flowchart may assist mining entities in making the assessment of whether a contract is, or contains, a lease and has been reproduced from paragraph B31 of IFRS 16.



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