KPMG

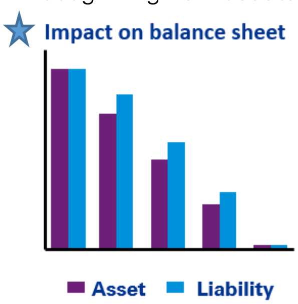
Insights into Mining

Issue 7, April 2016: An early look at the new lease standard for companies in the mining sector

Does your company lease significant assets for their own use? Are you ready for the new lease accounting rules?

The new standard at a glance

IFRS 16, *Leases*, the IASB's new lease accounting standard, requires lessees to bring most leases on-balance sheet, recognizing new assets and liabilities.

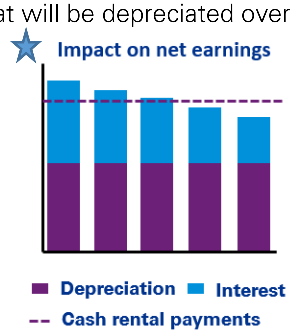


Beyond grossing-up the balance sheet, the new standard revises the lease definition, and may effect key performance measures, such as EBITDA, Cash From Operations and All in Sustaining Costs (AISC). Given the scale of this accounting change, we've summarized some of the key impacts of the new standard for companies in the mining sector.

The new leasing standard becomes effective in 2019, but there is an option to early adopt the standard if the new revenue standard has also been adopted.

The lessee model

From 2019, leases will be accounted for as if the lessee had borrowed funds to purchase an interest in the leased asset. To the extent that operating leases are brought on-balance sheet, companies will recognize a lease liability representing an obligation to make lease payments over the term of the lease and a "right of use" asset that will be depreciated over the term of the lease.



As a result of using the effective interest rate to accrete the lease liability, lessees will recognize a front-loaded pattern of expense, even when annual rental payments are constant. Importantly, rental expense will be replaced by a combination of depreciation expense arising from the recognition of the asset and interest expense arising from the lease liability.

The definition of a lease

A number of arrangements that are currently accounted for as leases may fall outside the new definition. For example, a power purchase arrangement may currently be considered a lease because the mine is taking all of the generating asset's electricity but does not pay a fixed or market price per unit. Under IFRS 16, it is also necessary to consider whether the lessee has the right to direct the use of the identified asset. This additional criteria may result in some leases, such as a power purchase arrangement, not meeting the definition of a lease under the new standard.

Sale-and-leaseback accounting

IFRS 16 largely eliminates sale-and-leaseback transactions as a potential source of off-balance sheet financing. Under the new standard, a seller-lessee will always recognize a sale-and-leaseback transaction on-balance sheet unless the leaseback meets one the exemptions in the standard.

Practical expedients

A lessee can elect not to apply the lessee accounting model to leases with a lease term of 12 months or less (i.e. short term leases) and to leases for which the underlying asset is of low value when it is new (even if the effect is material in aggregate). Companies should consider whether the practical expedients will

Assumes a single lease with a term of 5 years be used to deal with leases of certain office equipment and furniture, IT equipment (such as laptops) and leases of company cars.

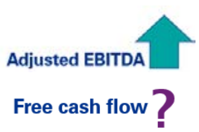
Things to think about now

In order to be ready for 2019, it is worth asking the following questions.

Which transition options to choose?
A key early decision is whether to elect to use the short-term lease and low value lease practical expedients and whether to elect to 'grandfather' the definition of a lease to existing contracts at transition to make the adoption of the standard less onerous.

There are two options for transition: fully retrospective and a modified retrospective approach (i.e. cumulative catch-up to R/E on transition). For many, the choice of transition method and which practical expedients to apply will have a major impact on the cost of implementing the standard and will need to be weighed against the comparability of financial information, and the effect on adoption on retained earnings.

What is the impact on key financial ratios?



Key financial ratios and non-GAAP measures may be affected by the recognition of new assets and liabilities and profits being recognized on a different basis from previously. EBITDA is expected to increase as previous rental payments will be categorized as payments to reduce the new lease liability and interest cost. Other measures, such as operating cash flow, may require further analysis to determine potential impacts and/or the need for definition changes. Those companies with the greater number of operating leases may see a larger reduction in AISC.

Should we consider changing our contracts?
To minimize the impact of the standard, both mining companies and their suppliers may wish to reconsider certain contract terms and business practices – e.g. changes in the structuring or pricing of a transaction, including lease length and renewal options. Of particular importance, will be how banks will consider the new lease liability and right-of-use asset for covenant calculations. Early conversations about the interpretation of definitions and the expected change to covenant ratios will help ease transition for both lenders and borrowers. Changes to these processes are likely to affect groups beyond finance - including legal and procurement.

All companies that lease major assets for use in their business will see an increase in reported assets and liabilities. The larger the lease portfolio, the greater the impact on key reporting metrics.

What are the immediate next steps?
Analysts and boards will be asking for early assessments of the impact of the new standard on financial results and key financial metrics.

Companies will need to begin to inventory existing operating leases and consider any systems and process changes, including changes to internal controls that are needed.

In parallel, accounting analysis should be performed to determine if arrangements, such as power purchase arrangements will no longer be leases, and decisions about transition options and practical expedients that may help ease the cost of transition should be weighed against the comparability of financial information and trend analysis.

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