



IFRS for mining

IFRS 16 *Leases*

Practical application guidance

February 2018

KPMG.com.au







Foreword

Welcome to KPMG's series of mining industry accounting thought leadership, *IFRS for Mining*.

These publications are focused on topical accounting issues and designed to provide finance teams with an overview of the key technical aspects of the matter and their application to the mining industry, including practical examples in a simple to interpret format. They are not designed to cover every aspect of the subject matter but provide a sound practical understanding, industry examples and access to tools to interpret the impact on your business.

IFRS 16 Leases is effective from 1 January 2019 and is an important change for all industries and mining is no different, particularly given the significant use of capital equipment. The standard is designed to provide greater clarity to preparers and users of financial statements and will result in most leases being recognised on balance sheet.

International standard setters have made changes to the identification, recognition and presentation of leases. Accordingly, a significant amount of additional detail and interpretation has been introduced. With this additional detail comes a need to fully understand the terms of existing and future contracts as the outcomes will differ based on the specific contractual arrangements.

This guide includes many industry examples and practical considerations as the mining industry participants work through the industry interpretations and impacts. We trust that you find this guide practical and helpful in your journey to implement the new IFRS 16 *Leases* standard.

KPMG Australia Mining Team
Part of the KPMG Global Mining Institute

For more information about the requirements of IFRS 16 *Leases*, refer to related KPMG resources on page 47

Executive Summary

IFRS 16: What do I need to know?

Headlines

- **Key financial metrics** will be affected by the recognition of new assets and liabilities, and differences in the timing and nature of lease expenses
- **Lease definition** replaces lease classification as the key on-/off- balance sheet test
- **There will be an increased focus on whether an arrangement contains a lease** and possible changes to whether transactions, such as service arrangements, contain leases
- **The impact may be broader than the finance team** as key contract terms, such as variable pricing mechanisms, will impact the value of leases on balance sheet
- **There are multiple transition options and practical expedients.** The transition method chosen may have a major impact on the cost of implementation and longer term effect of leases on the financial statements

IFRS 16 requires that most leases are recorded on balance sheet

Financial metrics impacted

- Profit before/after tax and non-IFRS measures such as EBIT/EBITDA*
- Depreciation/amortisation and interest expense
- Total assets and total liabilities

A change in financial metrics may impact a company's bank covenants and KPIs including those affecting bonus structures.

Communication with stakeholders requires careful consideration.

Section 3

Transition decisions

- Whether to grandfather the lease definition on transition
- Full retrospective or modified retrospective with optional practical expedients

Grandfathering provides a company relief from reassessing whether existing arrangements contain leases.

Whether to grandfather the lease definition and which transition option to apply may significantly impact the cost of implementation and comparability of financial results.

Section 7

* Earnings Before Interest, Tax, Depreciation and Amortisation as a non-IFRS measure

Contracts affected by the change may include



Service contracts which include use of assets



Shipping/transport contracts



Mining services/construction contracts



Rental contracts



Mine camp arrangements



Power supply contracts

Executive summary

Accounting for leases

There are a number of changes to lease accounting applying the requirements of IFRS 16, those resulting in specific implementation issues for the mining industry are covered within this publication. The key changes include:

Lease accounting	Lease definition	Lease and non lease components	Mining services contracts
<p>New assets and liabilities recognised on balance sheet for most leases.</p> <p>Variable pricing mechanisms significantly impact the value of leases on balance sheet.</p> <p>Section 3, 4</p>	<p>Additional guidance and examples on application of the definition, such as whether:</p> <ul style="list-style-type: none"> – a substitution right is substantive (practical and economically beneficial); and – a customer controls an asset. <p>Arrangements which contain leases may change.</p> <p>Section 1</p>	<p>Lessees allocate consideration to components based on relative stand alone prices whilst a lessor follows the principles of IFRS 15.</p> <p>Lessees can choose by class of underlying asset, to account for contracts which contain lease and non-lease components as leases in their entirety.</p> <p>Section 2</p>	<p>Mining services arrangements often depend on plant and equipment owned and operated by the contractor.</p> <p>Careful consideration of the lease definition will be required to assess whether contracts contain leases.</p> <p>Section 8</p>

Transition plan

The impact and relative effort required to implement the new standard will vary depending on the transition option selected but should not be underestimated. A key early decision is how to transition to the new standard. Some of the key tasks to include in your implementation plan include:

Current state assessment	Evaluation of contracts	Transition options	Disclosure requirements
<ul style="list-style-type: none"> – Build a database of all existing leases and contracts that may contain a lease – Consider completeness of existing lease portfolio 	<ul style="list-style-type: none"> – Develop IFRS 16 assessment process for existing contracts – Consider engaging with key business stakeholders outside of the finance team 	<ul style="list-style-type: none"> – Model the impact of transition options on financial metrics – Select transition option, considering the relative comparability and other benefits of available options 	<ul style="list-style-type: none"> – Disclose the impact of the new standard in financial reports prior to the date of initial application – Prepare for an increase in the disclosure burden for both lessees and lessors

KPMG can help

Assess the impacts



Help design a tailored approach



Help implement a future state



Refer to page 46 for further information about how KPMG can help, including tips and tools.



Contents

Which arrangements contain leases?	10
1 Lease definition.....	11
1.1 Is there an identified asset?.....	12
1.2 Does the customer obtain substantially all of the economic benefits?.....	17
1.3 Who has the right to direct the use of the asset?	19
2 Lease and non-lease components.....	23
Accounting for leases.....	26
3 Lessee accounting	27
4 Lessor accounting.....	30
Other considerations.....	32
5 Joint arrangements	33
6 Other financial reporting considerations.....	34
7 Transition method	35
8 Case study – Mining services contract.....	36
9 Next steps and other resources.....	44

Which arrangements contain leases?

A key judgement

Assessing whether an arrangement is, or contains, a lease will be one of the biggest practical issues when applying IFRS 16. In many cases, the assessment will be straightforward, and a transaction that is a lease today will be a lease under the new standard. In other cases, the assessment will be more complex, and the conclusion on whether an arrangement is, or contains, a lease may change.

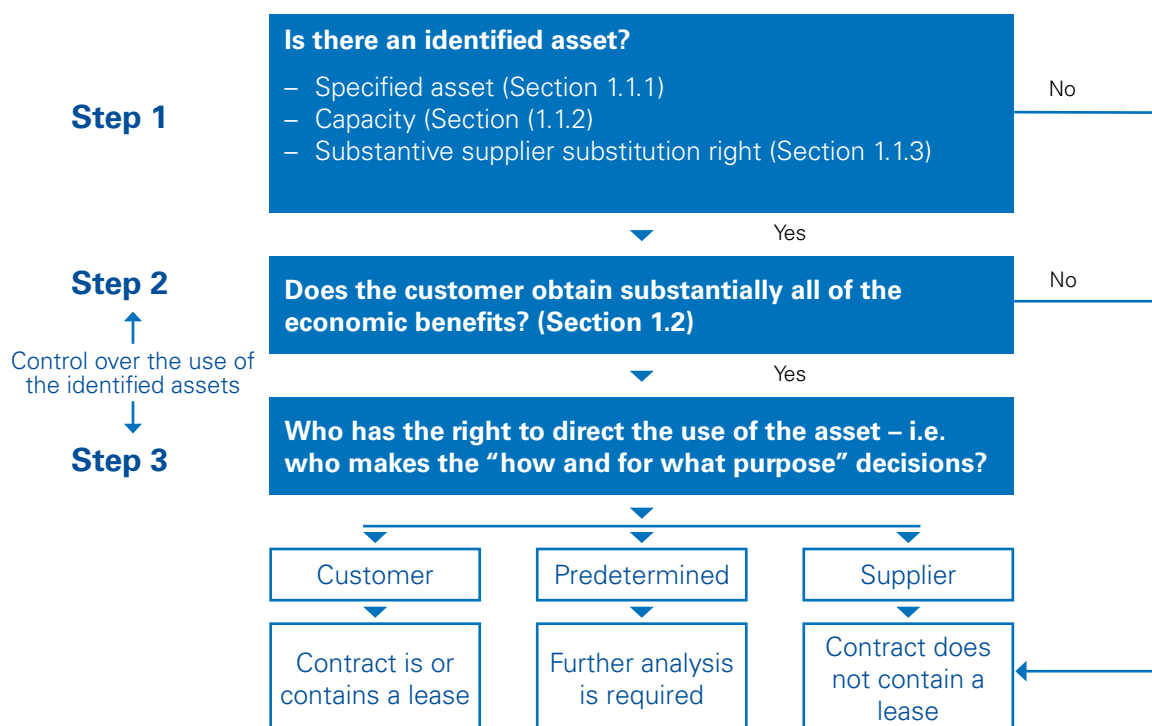
Companies should not underestimate the task ahead.

1 Lease definition

A lease is 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. If a contract contains a lease, then it will generally be on-balance sheet for the lessee.

The question of whether an arrangement is, or contains, a lease determines whether the arrangement is recognised on or off-balance sheet for lessees. The finance and operating lease classification test from IAS 17 *Leases* no longer applies to lessees but is however retained for lessors¹.

The key elements and some of the key considerations of the definition are as follows, all elements of the definition must be met in order for there to be a lease.



Observation

IFRS 16 has an increased focus on who has the right to control the use of an identified asset, and contains additional application guidance and illustrative examples on right to direct the use, plus more explicit guidance on whether there is an asset.

¹ Refer to section 4 for further information.

Practical expedient

On transition, there are a number of options available to companies. The practical expedient to grandfather previous assessments under IAS 17 and IFRIC 4 *Determining whether an Arrangement contains a Lease* of which contracts are, or contain, leases, offers considerable relief on transition. Without this relief, companies would be required to reassess all previous decisions about which contracts are, or contain, leases applying the IFRS 16 lease definition. This practical expedient is therefore likely to prove popular.

If this practical expedient is applied, the IFRS 16 definition of a lease is applied only to contracts entered into from the date of initial application. From the date of initial application, lease accounting under IFRS 16 is applied to all leases, including those identified applying the requirements of IAS 17 and IFRIC 4. Refer to section 7 for further discussion over transition.

Observation

A robust process is required to ensure all leases were identified under IAS 17 and IFRIC 4 for contracts entered into prior to the date of initial application of IFRS 16.

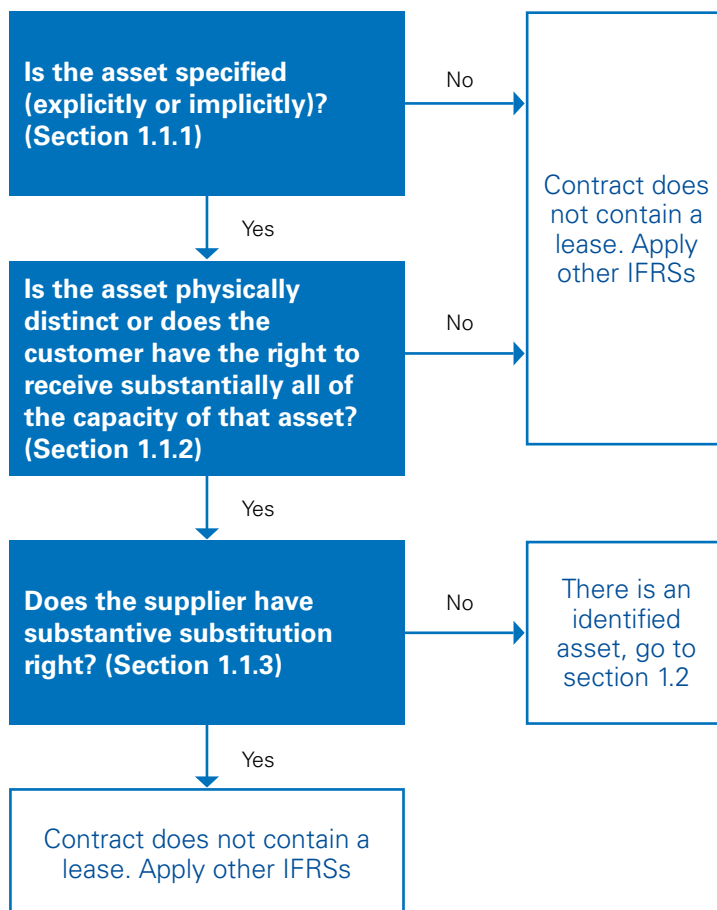
During the course of the IFRS 16 implementation project, it is possible that some companies will identify leases in existing contracts, under IAS 17 and IFRIC 4.

Step 1

Is there an identified asset?

1.1 Overview

For a lease to exist, there has to be an identified asset, determined as follows:



1.1.1 Specified asset

A contract contains a lease only if it relates to an identified asset. There may be an identified asset if there is a specified asset. An asset can be either explicitly specified in a contract or is implicitly specified at the time it is made available for use by the lessee.

Which arrangements contain leases?

Example 1.1.1.1 – Remote site power purchase contract: Asset is specified

It is common for mining companies to operate in remote locations. A power plant may be an implicitly specified asset in a power purchase contract if the customer's facility is in a remote location with no access to the grid, such that the supplier cannot buy the required energy in the market or generate it from alternative power plants.

Example 1.1.1.2 – Mining equipment contract: Asset is specified

A supplier may enter into a binding contract to supply an excavator to a customer for use on the customer's mine site in six months time. The specific excavator is not identified at the date of signing the contract, the supplier has four excavators of a similar specification that could be used to fulfil the contract. All four excavators are at a similar distance from the customer's mine site. However, once a given excavator is transported to the mine site, only that excavator can be used to fulfil the contract. In this case, although the contract does not initially specify which excavator will be used to fulfil the contract, the individual excavator is specified when it is made available to the customer.

Question: What does implicitly specified mean?

An asset is implicitly specified if the facts and circumstances indicate that the supplier can fulfil its obligations only by using a specific asset.

Question: Does an asset need to be specified at contract inception?

No, the key test is whether the asset is specified at the time when it is made available to the customer.



Observation

IFRIC 4 did not address capacity portions, resulting in diversity in practice. The requirements of the IFRS 16 lease definition are new, therefore the impact will depend on how an entity previously approached capacity portions in a lease identification assessment under IFRIC 4.

Question: What does 'substantially all' mean?

The new standard does not define 'substantially all' in the context of the definition of a lease. US GAAP allows the use of a threshold of 90 percent for 'substantially all'. Although 90 percent may provide a useful reference point, it does not represent a bright-line or automatic cut-off point under IFRS. For the purpose of applying the lease definition, a company should develop an interpretation of 'substantially all' and apply it on a consistent basis.

1.1.2 Capacity portions

In many cases, the asset subject to the contract will be the entire underlying asset and therefore easy to identify (e.g. a building or a piece of equipment). However, a portion of an asset's capacity can be an identified asset if:

- it is physically distinct (e.g. a floor of a building or a specified strand of a fibre-optic cable); or
- it is not physically distinct, but the customer has the right to receive substantially all of the capacity of the asset (e.g. a capacity portion of a fibre-optic cable that is not physically distinct but represents substantially all of the capacity of the cable).

Example 1.1.2.1 – Warehouse storage: Capacity portion is not an identified asset

Zinc miner A enters into an arrangement with Storage Co B for the right to store zinc at B's specified warehouse at a port. The warehouse has no separate compartments. At inception of the contract, A has storage rights which permit it to use up to 40% of the capacity of the warehouse throughout the term of the contract. B can use the other 60% of the warehouse as it sees fit.

In this scenario, there is no identified asset. This is because A only has rights to 40% of the warehouse's capacity and that capacity portion is neither physically distinct from the remainder of the warehouse nor 'substantially all'.

Example 1.1.2.2 – Warehouse storage: Capacity portion is an identified asset

Contract miner C enters into an arrangement with Mining Co D for the right to store equipment spare parts at a specified storage warehouse. Within this warehouse, rooms 1 and 2 are contractually allocated to C for its exclusive use. D has no substitution rights. Rooms 1 and 2 represent 40% of the warehouse's total storage capacity.

In this scenario, there is an identified asset even though C is using only 40% of the warehouse's total storage capacity. This is because:

- the rooms are explicitly specified in the contract;
- the rooms are physically distinct from the other storage rooms within the warehouse; and
- D has no substitution rights.

Which arrangements contain leases?

1.1.3 Substantive supplier substitution rights

Even if an asset is specified in a contract, a customer does not have the use of an identified asset if the supplier has a substantive right to substitute the asset for an alternative asset throughout the period of use.

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.

Example 1.1.3.1 – Trucking: Substitution rights are substantive

Nickel miner E enters into a five-year contract with a transport carrier (Supplier F) to transport a specified quantity of nickel ore. F uses trucks of a particular specification that are stored at its premises and has a large fleet of similar trucks that can be used to fulfil the requirements of the contract.

The trucks are stored at F's premises and F has a large fleet of similar trucks, in this case it appears that F has the practical ability to substitute the trucks.

Costs associated with substituting the trucks are minimal for F. Relevant experience demonstrates that:

- F benefits economically from being able to deploy alternative trucks as necessary to fulfil customer needs; and
- the conditions that make substitution economically beneficial (e.g. the nature and mix of different customer needs for F's assets) are likely to continue throughout the period of use.

As F has the practical ability to substitute the trucks and their substitution is economically beneficial throughout the period of use, F's substitution rights are substantive and the arrangement does not contain a lease.

Observation

Substitution rights is one of the key areas of focus in applying the lease definition. Some elements of substitution are often permitted in leases of fleets of vehicles or equipment and the guidance which the new standard provides is more detailed. Under IFRS 16 a right is substantive only if the lessor (supplier) would benefit economically from substitution, whereas IFRIC 4 required only that substitution is 'economically feasible'.

This suggests that demonstrating a substantive substitution right will be a higher hurdle under the new standard than under IFRIC 4 as a result of the additional guidance.

Question: What if a customer cannot readily determine whether a supplier has a substantive substitution right?

The customer should presume that any substitution right is not substantive.

Which arrangements contain leases?

Observation

Judgement will be required to evaluate whether the economic benefits will outweigh the costs of substitution because the analysis is performed from the supplier's perspective.

It is more difficult for the customer to determine whether the supplier's substitution right is substantive.

Question: Is a supplier's right or obligation to substitute the asset for repairs and maintenance a substantive substitution right?

No, a right to substitute the asset because the asset is not working properly or being maintained – i.e. a 'warranty-type' obligation, or a vehicle requiring maintenance, is not considered to be a substantive substitution right. (IFRS 16.B18)

Observation

Replacing a piece of equipment for a different piece of equipment with different capabilities would not be assessed to be substitution.

Example 1.1.3.2 – Underlying asset is significantly customised: Substitution is not substantive

Underground gold miner G enters into an arrangement with Supplier H for a significantly customised underground crusher to crush ore mined. H has the right to substitute the crusher without G's consent throughout the term of the contract. There are no other similarly customised underground crushers in the supplier's portfolio, nor readily available from other suppliers.

In this scenario, the substitution right is not substantive because a similarly customised underground crusher is not readily available and therefore H does not have the practical ability to substitute. Therefore, there is an identified asset.

Example 1.1.3.3 – Mining equipment lease: Substitution right is not substantive

Bauxite miner K enters into a contract with Supplier L for the rental of 10 100T trucks for 5 years. L has a total fleet of 60 100T trucks, the remainder of which are located either at either L's depot or other customers' sites which are more than 1000km from K's mine site. L has a right to substitute trucks throughout the period of the contract.

K does not know the availability of the L's alternative trucks throughout the period of use, and the alternative trucks are located more than 1000km from K's site, therefore K is unable to conclude that there is a practical ability to substitute throughout the period of use.

Costs will be incurred by L to substitute trucks, including transport costs and lost revenue whilst substituting. K is unable to determine whether the economic benefit will exceed the costs of substitution, therefore K presumes that the substitution right is not substantive and that there is an identified asset

Example 1.1.3.4 – Overhaul of an excavator: Substitution right is not substantive

A customer enters into a contract for the right to use an excavator on its mine site for 8 years. After 4 years, the excavator is expected to require a full overhaul. The supplier will provide a substitute excavator to service the remaining 4 years of the contract. In our view, the supplier's right to substitute for the purpose of an overhaul is not a substantive substitution right because it is akin to repairs and maintenance.

Step 2

Does the customer obtain substantially all of the economic benefits?

1.2 Overview

A contract contains a lease only if the customer obtains substantially all of the economic benefits.

The economic benefits from using an asset include its primary output (ie. goods or services), by-products (e.g. renewable energy credits that are generated through use) and other economic benefits from using the asset that could be realised from a commercial transaction with a third party (e.g. sub-leasing the asset).

Refer to Section 1.1.2 for a discussion of 'substantially all'.

Example 1.2.1 – Solar plant: Customer receives substantially all of the economic benefits from use

Zinc miner M enters into a 25-year contract with Power Co N to purchase all of the electricity produced by a new solar plant. N owns the plant and will receive tax credits relating to the construction and ownership of the plant, and M will receive renewable energy credits that accrue from use of the plant.

M has the right to obtain substantially all of the economic benefits from use of the plant over the 25-year period because it obtains:

- the electricity produced by the plant over the lease term – i.e. the primary product from use of the asset; and
- the renewable energy credits – i.e. the by-product from use of the asset.

Although N receives economic benefits from the plant in the form of income tax credits, these economic benefits relate to the ownership of the plant. The tax credits do not relate to the use of the plant and therefore are not considered in this assessment.

Observation

In evaluating whether the customer has the right to obtain substantially all of the economic benefits from the use of an asset, a company considers the economic benefits that can be derived from the asset within the defined scope of the customer's right to use.

For example, a mining company leases a haulage truck that it can operate only within the state of Western Australia during the 5-year contract term. When assessing whether the mining company has the right to obtain substantially all of the economic benefits from use of the haulage truck, only the economic benefits for the permitted location are considered, and not beyond.

Example 1.2.2 – Solar plant

Amending example 1.2.1:

Zinc miner M obtains the electricity produced by the plant over the lease term.

Power Co N obtains the renewable energy credits from use of the asset, and receives economic benefits from the plant in the form of tax credits relating to ownership of the plant.

It is not clear whether M does receive all of the economic benefits from use of the plant. Further analysis would be required to determine whether M obtains substantially all of the economic benefits from use of the plant.

Example 1.2.3 – Land easement for railway: Customer obtains substantially all of the economic benefits from use

Easements are commonly used in a variety of industries. A mining company enters into an arrangement with a landowner (grantor) for an easement right over the grantor's farmland to construct and have exclusive use of a railway. The land on which the railway is built will be specified either explicitly in the easement contract with the landowner or will become specified once made available for the customer's use.

When assessing whether the customer obtains substantially all of the economic benefits from use of the land easement, whether the grantor can realistically obtain economic benefits from using the land is considered.

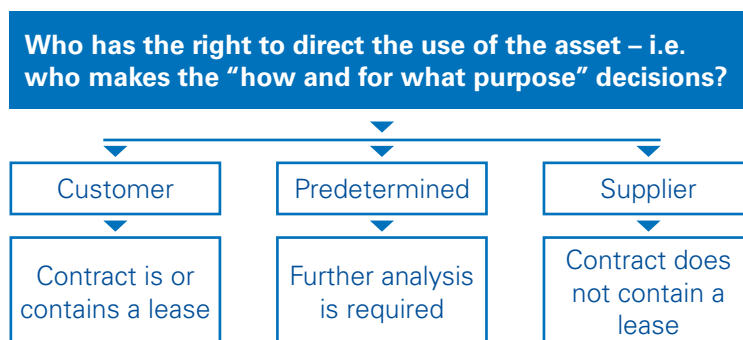
If the grantor cannot use the land over which the easement is granted for any other purpose, the customer obtains substantially all of the economic benefits from use of the land easement.

Step 3

Who has the right to direct the use of the asset?

1.3 Overview

A contract contains a lease only if the customer directs the use of the asset.



A customer has the right to direct the use of an identified asset in either of the following situations:

- the customer has the right to direct “how and for what purpose” the asset is used throughout the period of use; or
- the relevant decisions about how and for what purpose the asset is used are predetermined, and:
 - 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
 - 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.

Observation

Under IFRIC 4, an arrangement conveyed the right to use an asset if any one of the following three specific criteria are met:

- the customer has the ability or right to operate the asset, including to direct how others operate the asset, while obtaining more than an insignificant amount of the output; or
- the customer has the ability or right to control physical access to the asset while obtaining more than an insignificant amount of the output; or
- no other party takes more than an insignificant portion of the output and the unit price of the output is neither fixed nor at market.

Meeting the above criteria will not necessarily result in a lease being identified under IFRS 16 which requires a more comprehensive analysis of control, including who makes the “how and for what purpose decisions”.

This is likely to mean that some agreements that are currently treated as leases may fall outside the new lease definition. For example, under some power purchase agreements, a customer may obtain all of the output from the plant and pay a price that is not fixed or market price, such as plant operating costs plus a margin. Such an arrangement may have been identified as a lease applying the requirements of IFRIC 4, however applying IFRS 16, the way in which output is priced is not a relevant consideration but the assessment rather focusses on whether the customer controls the asset.

Which arrangements contain leases?

“How and for what purpose” decisions

A company considers the decision-making rights that are most relevant to changing how and for what purpose the asset is used – ‘relevant’ in the sense that they affect the economic benefits derived from use.

Examples of relevant decisions that, depending on the circumstances, grant the right to change how and for what purpose the asset is used include the following:

- What: Rights to change the type of output that is produced by the asset (e.g. deciding whether to use a shipping container to transport goods or for storage).
- When: Rights to change when the output is produced (e.g. deciding when a power plant will be used by issuing instructions of when electricity is required).
- Where: Rights to change where the output is produced (e.g. deciding on the destination of a truck or a ship).
- Whether and how much: Rights to change whether the output is produced, and the quantity of that output (e.g. deciding whether to produce energy from a power plant and how much energy).

Determining who makes the “how and for what purpose” decisions

In assessing whether a customer has the right to direct the use of an asset, a company considers only the rights to make decisions about the asset’s use during the period of use. Decisions that are predetermined before the period of use – i.e. commencement date – are not considered.

Examples of decision-making rights that do not grant the right to change how and for what purpose the asset is used include rights that are limited to operating an asset based on the decisions about how and for what purpose the asset is used, or maintaining an asset.

A contract may include certain terms and conditions designed to protect the supplier’s interest in the identified asset or other assets, to protect its personnel or to ensure the supplier’s compliance with laws or regulations. Such protective rights typically define the scope of the customer’s right to use an asset but do not, in isolation, prevent the customer from having the right to direct the use of the asset within that scope.

Example 1.3.1 – Cargo ship: Customer makes the “how and for what purpose” decisions

Customer P enters into a five-year contract with Supplier Q, a ship owner, for the use of an identified ship. P decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent P from sailing the ship into waters at a high risk of piracy or carrying explosive materials as cargo. Q operates and maintains the ship, and is responsible for safe passage.

P has the right to direct the use of the ship. The contractual restrictions are protective rights that do not have the right to change how the ship is used but protect Q’s investment in the ship and its personnel. Within the scope of its right of use, P determines how and for what purpose the ship is used throughout the five-year period because it decides whether, where and when the ship sails, as well as deciding the cargo that it will transport. Q does not have the right to change these decisions throughout the period of use.

Which arrangements contain leases?

Example 1.3.2 – Construction contract: Customer does not make the “how and for what purpose” decisions

Mining Co R enters into a contract with Construction Co S to construct a processing plant designed by R on R's property. The project is expected to take 15—20 months to complete.

The nature of the construction services is such that S will use a variety of construction equipment it owns to fulfill the contract. During the construction period, the various pieces of equipment are implicitly specified because S will not, under circumstances likely to occur or exist throughout the period of use, economically benefit from substituting the equipment it commits to the project for equivalent equipment during the construction period (the period of use). Therefore, the pieces of equipment are identified assets.

While the pieces of equipment are identified assets, and implicitly specified to R's construction project, R does not control their use. At no point during the period of use does R have the right to direct how and for what purpose any of the identified equipment is used. S makes the decision around how to construct and accordingly what and how to use various individual assets. While R has specified an output from the use of the equipment as a unit (the constructed processing plant), R has no rights to decide how S employs any individual piece of equipment to fulfill the construction contract. Rather, it is S that, throughout the period of use, will solely decide how each piece of equipment is used to complete the numerous tasks necessary to fulfill the contract.

Example 1.3.3 – Mine camp contract: Customer makes the “how and for what purpose” decisions

Remote Miner T enters into a 4 year contract with Supplier U for the use of mine camp accommodation units. The units to be used are explicitly specified in the contract and cannot be substituted. U is responsible for maintenance of the units. Compensation is based on occupancy rates. T will have exclusive use of the accommodation units throughout the 4 year contract.

T can make the following decisions:

- where the accommodation units will be situated on the mine site;
- when and whether the units are occupied.

What the units are to be used for i.e. for accommodation purposes, is predetermined by the contract.

In this example, T can change where the units are situated, when, whether and how much the units are used, therefore makes the how and for what purpose decisions throughout the period of use and therefore directs the use.

Question: What if the customer and the supplier each make some of the “how and for what purpose” decisions?

Judgment is required to assess the individual significance of the different how and for what purpose decisions i.e. their impact on the economic benefits. If some decisions have greater significance than others, then the party that makes the more significant decisions generally directs the right to use the asset.

Which arrangements contain leases?

Question: What if only some of the “how and for what purpose” decisions are predetermined?

If some but not all of the relevant decisions about how and for what purpose the asset is used are predetermined, then the assessment includes only those relevant decisions that are not predetermined.

For example, Mining Co V enters into a contract with Pipeline Operator W to obtain exclusive use of W’s water pipeline for a period of 25 years. In this case, the decisions over what is transported (i.e. water) and where it is transported (from the beginning to the end of the pipeline) are predetermined,

Therefore, the analysis will focus on determining whether the supplier or the customer has the right to make the relevant decisions that are not predetermined – i.e. whether, when and how much water is transported through the pipeline.

Example 1.3.4 – Shipping contract: “How and for what purposes” decisions are predetermined

Coal miner T enters into a four-year contract with Shipping Co U, a shipping company, to transport coal from Australia to China. The ship to be used is explicitly specified in the contract and cannot be substituted. T’s cargo will occupy substantially all of the capacity of the ship. The contract specifies the cargo to be transported and dates of pickup and delivery. T hires the captain; the rest of the crew is provided by U.

In this example, all of the decisions about how and for what purpose the asset is used are predetermined because the contract specifies when and where the ship sails, as well as the cargo to be transported. The ship was not designed by T, but T may operate the ship because the ship’s captain is hired by T. Although the ship cannot be operated without the rest of the crew (which is provided by U), it is usually the captain who makes the (major) operational decisions and gives instructions. In this scenario, it is likely that T operates the ship and consequently has the right to direct its use.

Have I thought of everything?

It may take a substantial effort to identify all lease agreements and extract all relevant lease data.

This is not an exhaustive list however to aid your implementation process, we highlight some arrangements which are common for mining companies to be party to and which may contain leases below.

Arrangements to consider:

Shipping	Mining services contracts	Camp / accommodation contracts
Port access	Rail usage	Power purchase contracts
Land easements	Equipment hire	Trucking and haulage contracts

For more information about the requirements of IFRS 16 *Leases*, refer to related KPMG resources on page 47.

2 Lease and non-lease components

Companies often enter into arrangements for services, which may include a right to use assets. If a contract is, or contains a lease, then the company accounts for each separate lease component, separately from non-lease components e.g services.

A company considers the right to use an underlying asset as a separate lease component if it meets the following criteria:

- the lessee can benefit from using that underlying asset either on its own or together with other resources that are readily available; and
- the asset is neither highly dependent on, nor highly inter-related with, the other assets in the contract.

If a contract contains a lease component and one or more additional lease and non-lease components, then the lessee allocates the consideration in the contract to each component on the basis of:

- the relative stand-alone price of each lease component; and
- the aggregate stand-alone price of the non-lease components.

Observation

Charges for administrative tasks or other costs incurred associated with the lease that do not transfer a good or service to the lessee do not give rise to a separate component. However, they are part of the total consideration that a company allocates to the identified components.

Question: What if an observable stand-alone price is not readily available?

A lessee estimates the stand-alone price of the components by maximising the use of observable information. A lessor however allocates consideration in accordance with the requirements of IFRS 15 Revenue from Contracts with customers.



Example 2.1 – Equipment and maintenance services contract: Lease and non-lease components

Lessee V enters into a five-year lease contract with Lessor W to use conveyor equipment. The contract includes W operating the conveyor. W obtains its own insurance for the conveyor equipment. Annual payments are \$2,000 (\$300 relate to operating and \$50 to insurance costs). V is able to determine that similar operating services and insurance costs are offered by third parties for \$400 and \$50 respectively per year. V is unable to find an observable stand-alone rental amount for similar mining equipment because none are typically leased without related operating services provided by the lessor.

In this case:

- the observable stand-alone price for operating services is \$400;
- the estimated stand-alone price of the conveyor is \$1,750;
- the insurance cost does not transfer a good or service to the lessee and therefore is not a separate component.

Components	Stand-alone price	Selling price ratio	Price allocation
Lease	1,750	81%	1,628 (2,000x81%)
Operating services	400	19%	372 (2,000x19%)
Insurance	-	-	-
Total	2,150	2,000	

\$1,628 is allocated to the lease component and \$372 to the non-lease (service) component.

Practical expedient

A lessee can elect, by class of underlying asset, not to separate lease components from any associated non-lease components. A lessee that takes this election accounts for the lease component and the associated non-lease components as a single lease component.

Unless a lessee applies the practical expedient, it accounts for non-lease components in accordance with other applicable standards.

Applying the practical expedient to example 2.1, lessee V would combine the lease and non-lease (service) components and account for them as a single lease component of \$2,000 (\$1,628 plus \$372). This will result in the recognition of a higher lease liability and right-of-use asset, and therefore higher interest and depreciation, impacting financial metrics such as EBITDA.

For more information about the requirements of IFRS 16 *Leases*, refer to related KPMG resources on page 47.



Accounting for leases

Significant judgement may be required to determine the inputs into the lease liability and right of use asset, including:

- **Which payments are included within the lease liability?**
- **What discount rate should be used to discount the lease payments?**
- **What is the lease term where the right to use an asset is not for a fixed term?**

These questions will be relevant for all leases, and are especially relevant for service arrangements containing leases such as mining services contracts.

3 Lessee accounting

The new standard eliminates the current operating/finance lease dual accounting model for lessees. Instead, there is a single, on-balance sheet accounting model, similar to current finance lease accounting.

<p>Balance sheet</p> <p>Asset = Right-of-use of underlying asset</p> <p>Liability = Obligation to make lease payments</p>	<p>Profit or loss - Lease expense</p> <p>Depreciation + Interest = Front-loaded total lease expense</p>
--	--

Initial measurement of the lease liability

At the commencement date, a lessee measures the lease liability at the present value of the future lease payments.

Lease liability	=	Present value of lease payments	+	Present value of expected payments at end of lease
------------------------	---	---------------------------------	---	--

The lease term, lease payments and discount rate are key inputs in the calculation of the lease liability and may require significant judgement to determine.

Lease term	Non-cancellable period of the lease, together with optional renewable periods if the lessee is reasonably certain to extend, and periods after an optional termination date if the lessee is reasonably certain not to terminate early.
Lease payments	<ul style="list-style-type: none"> – Fixed payments (including any in-substance fixed payments) less any lease incentives receivables; – Variable lease payments that depend on an index or a rate; – Amounts expected to be payable by the lessee under residual value guarantees; – The exercise price of a purchase option that the lessee is reasonably certain to exercise; and – Payments for terminating the lease if the lease term reflects early termination.
Discount rate	Interest rate implicit in the lease if this can be readily determined. Otherwise, the lessee uses its incremental borrowing rate.

Question: If the contract price is fully variable based on usage, does this mean there will be no lease liability and right-of-use asset to recognise?

Yes. Only variable lease payments that depend on an index or a rate are included in the lease liability and recognised on balance sheet. It is however relevant to consider whether there are in-substance fixed payments (those which are in substance unavoidable) included within the variable payment arrangement. For example, where there is a contractual minimum lease rental payable this would be an in-substance fixed payment which is included in the lease liability.

Observation

There are significant judgements required in calculating the lease liability:

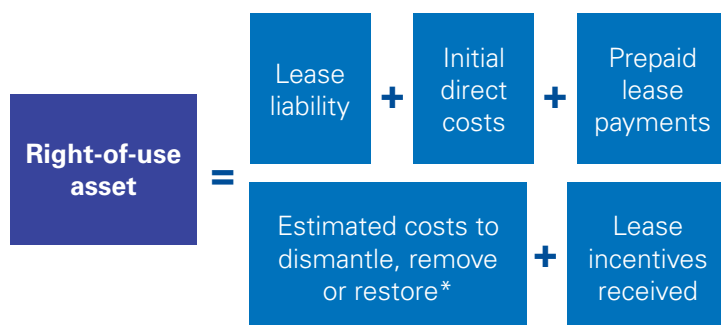
- a company has to consider lease term, lease payments and discount rate; and
- a company also has the option to apply the practical expedient not to separate and apply lease accounting for the entire contract for arrangements that contain lease and non-lease components.

Example 3.1 – Equipment contract: Lease term

Modifying example 2.1, assume that the contract has no fixed term and lessee V has an option to terminate or renew the contract annually. V uses the conveyor equipment to transport coal from the processing plant to the warehouse at the port and has a contract to sell coal and a mine life of 5 years. In this case, the ability of V to meet the requirements of the contract are dependent on the use of conveyor equipment and it appears that the customer is reasonably certain to renew the contract annually for the duration of the sale contract and mine life. Therefore the lease term is 5 years.

Initial measurement of the right-of-use (ROU) asset

At the commencement date, a lessee measures the right-of-use asset at a cost that includes the following:



** Measured in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets*



Accounting for leases

A lessee's initial direct costs are the incremental costs of obtaining a lease that would otherwise not have been incurred.

Subsequent measurement of the lease liability

After initial recognition, the lease liability is measured at amortised cost using the effective interest method.

When there is a change in the factors listed below, a lessee remeasures the lease liability using the discount rate indicated:

- Expected amount payable on the residual value guarantee
- Index or rates (other than floating interest rates)
- In-substance fixed payments

Unchanged discount rate

- Lease term
- Floating interest rates
- Assessment of purchase options

Revised discount rate

Subsequent measurement of the Right-of-use asset

Generally, right-of-use assets are depreciated and are subject to impairment testing in accordance with IAS 36 Impairment of non-financial assets.

If the ROU asset meets the definition of investment property, the ROU asset is measured in accordance with its accounting policy for other investment properties, which may be at fair value.

If the ROU asset relates to a class of property, plant and equipment that are revalued under IAS 16 *Property, plant and equipment*, then it may apply the revaluation model to all ROU assets that belong to the same class.

Observation

It is common for mining companies to recognise provisions for restoration under IAS 37. Where restoration relates to a leased asset e.g. decommissioning of a power plant, the rehabilitation asset will be included in the ROU asset. This may result in a change in the balance sheet classification of the restoration asset.

For more information about the requirements of IFRS 16 *Leases*, refer to related KPMG resources on page 47.

4 Lessor accounting

Observation

A key consequence of the decision to retain the IAS 17 dual accounting model for lessors is a lack of consistency with the new lessee accounting model.

This can be seen where a lessor classifies a lease as an operating lease:

- the lessee applies the right-to-use model and recognises a right-of-use asset and a liability for its obligation to make lease payments; whereas
- the lessor continues to recognise the underlying asset and does not recognise a financial asset for its right to receive lease payments.

Question: Are there any changes to lease accounting for lessors under IFRS 16?

Yes. Whilst the lease classification test is essentially unchanged from IAS 17, there are a number of changes in the details of lessor accounting, for example, lessors apply the new definition of a lease. There are also changes to sale-and-leaseback, sub-lease, lease modification and disclosure requirements.

Lessor accounting under IFRS 16 remains similar to current requirements under IAS 17. A lessor continues to apply the “dual accounting model,” and classifies a lease as either a finance lease or an operating lease, as follows:

- leases that transfer substantially all of the risks and rewards incidental to ownership of the underlying asset are finance leases; and
- all other leases are operating leases.

Similar to lessees, there may be arrangements accounted for as leases under IAS 17 and IFRIC 4 which would not be leases applying the new definition in IFRS 16, and arrangements which are currently accounted for only as service contracts may be treated as containing leases.

For lessors, whilst the contracts which contain leases may change as a consequence of the new lease definition, consistent with the finance lease and operating lease accounting models in IAS 17:

- for operating leases, the underlying asset will continue to be recognised on the lessor’s balance sheet
- finance leases result in the underlying asset being derecognised and a finance lease receivable recognised.

Initial measurement of the finance lease receivable

A lessor initially measures a finance lease receivable at the present value of the future lease payments plus any unguaranteed residual value accruing to the lessor. The lessor discounts these amounts using the rate implicit in the lease.

A lessor includes fixed payments (including in-substance fixed payments), less lease incentives payable, variable payments that depend on an index or rate, residual value guarantees provided to the lessor at the guaranteed amount, the exercise price of purchase options if the lessee is reasonably certain to exercise; and termination penalties payable in accordance with the expected lease term.

The lease classification test is essentially unchanged from IAS 17. This is illustrated below.

IAS 17 and IFRIC 4		IFRS 16	
Lease identification	Balance sheet	Lease identification	Balance sheet
Lease exists – lessor classifies the lease as either a finance or operating lease	Finance lease: derecognise underlying asset and recognise finance lease receivable	If a lease exists, a lessor would classify the lease as a finance lease	Finance lease: derecognise underlying asset and recognise finance lease receivable
	Operating lease: continue to recognise underlying asset	If no lease exists	No change to recognition of underlying asset
No lease exists	No change to recognition of underlying asset	If a lease exists, a lessor would classify the lease as an operating lease	Operating lease: continue to recognise underlying asset
		If no lease exists	No change to recognition of underlying asset
		If no lease exists	No change to recognition of underlying asset
		If a lease exists, a lessor would classify the lease either as a finance or operating lease	Account for the lease as either operating or finance as above

Example 4.1 – Mining services contract: Lease exists applying existing and new lease definitions, lease is classified as a finance lease in both cases

A contractor enters into a lease with a mining company over a fleet of 10 trucks to be used in the customer’s mining operation. The contract provides a put option over the equipment at the contractor’s (lessor’s) option that the contractor may exercise, requiring the customer to purchase the mining equipment for a predetermined amount. The arrangement is assessed to contain a lease under both IAS 17 and IFRS 16. The lease is accounted for as a finance lease as substantially all of the risks and rewards of ownership are transferred to the lessee.

For more information about the requirements of IFRS 16 *Leases*, refer to related KPMG resources on page 47.

Other considerations

The impact of IFRS 16 will not be limited to accounting for leases.

Other areas that companies need to consider during the transition process include:

- **joint arrangements**
- **other financial reporting considerations**
- **transition method.**

5 Joint arrangements

It is common for mining companies to be a party to a joint arrangement (i.e. a joint venture or a joint operation).

Identifying the customer when a joint arrangement is involved is critical in determining whether there is a lease. A joint arrangement is considered to be the customer when the contract is either entered into by the joint arrangement itself, or signed by one or more of the parties to the joint arrangement on behalf of the joint arrangement.

When the joint arrangement is the customer, the contract contains a lease if the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use through their joint control of the arrangement.

If there is a lease, then:

- in the case of a joint operation, each party to the joint operation accounts in its own financial statements for its share of the right-of-use asset and its share of the lease liability; and
- in the case of a joint venture, the right-of-use asset and the lease liability are recognised in the financial statements of the joint venture and not in the financial statements of the individual venturers.

Observation

In practice, questions may arise about whether a joint operator enters a contract as a principal in its own name or on behalf of the joint operation. Judgement applies and the individual facts and circumstances – including the legal environment – should be considered.

For more information about the requirements of IFRS 16 *Leases*, refer to related KPMG resources on page 47.



6 Other financial reporting considerations

There are a number of other areas of financial reporting which are impacted by lease accounting. On transition, companies need to consider the wider impact of IFRS 16, the following areas may require amendment on transition:

- Inventory costing and deferred stripping assets accounting policies – IAS 2 *Inventories* requires the cost of inventory to include costs of conversion and other costs incurred in bringing the inventories to their present condition. IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* requires the cost of the stripping asset to include costs directly incurred to perform the stripping activity. It is common for the depreciation of assets under finance lease and operating lease rentals under IAS 17 to be capitalised to the cost of inventory where they are costs directly related to the units of production and to deferred stripping assets. Similarly, under IFRS 16, depreciation of ROU assets and lease payments may be capitalised to the cost of inventory and deferred stripping assets where they meet the criteria for capitalisation in line with accounting standards. For example, IAS 23 *Borrowing costs* may include the interest in respect of lease liabilities under IFRS 16, these costs may only be capitalised where the criteria under IAS 23 are met.
- Business combination accounting – Where the acquiree is a lessee, under IFRS 3 *Business Combinations* the acquirer shall measure the lease liability at the present value of remaining lease payments as if the acquired lease were a new lease at the acquisition date, using the discount rate at acquisition date. The acquirer shall measure the ROU asset at the same amount as the lease liability.
- Impairment assessment process – Operating lease payments may previously have been included when calculating the recoverable amount for a CGU using a discounted cash flow model. Similar to finance lease liabilities under IAS 17, lease liabilities under IFRS 16 are financing liabilities, therefore cash flows associated with on balance sheet leases should be excluded from the cash flow model where lease liabilities are excluded from the carrying value, but ROU assets are included in the carrying value.
- Cash flow statement presentation – Under IAS 17, operating lease payments are presented within operating cash flows. Under IFRS 16, lessees will recognise leases in the income statement as depreciation of ROU assets and interest in respect of lease liabilities. In the cash flow statement:
 - depreciation and interest will be presented within operating cash flows
 - payments reducing the lease liability are presented within financing cash flows.

7 Transition method

A key next step is to evaluate which transition method to apply. There are different options available, including fully retrospective or modified retrospective and a host of different practical expedients. Many of the options and expedients can be elected independently of each other.

Most of the choices you have to make on transition involve a trade-off between cost and comparability. That is, the options and expedients that simplify and reduce the costs of transition tend to reduce the comparability of your financial information. Choosing the best transition option for your business will require thought – and probably some detailed modelling of alternative approaches.

Except for sub-leases and sale-and-leaseback transactions, a lessor is not required to make any adjustments on transition. Instead, a lessor accounts for its leases in accordance with IFRS 16 from the date of transition.

The practical expedient to grandfather the definition of a lease on transition offers considerable relief on transition. Without this relief, companies would be required to reassess all of their previous decisions about which existing contracts do and do not contain leases. The practical expedient is therefore likely to prove popular, however companies will need to assess all contracts which commence before the date of initial application applying the requirements of IAS 17 and IFRIC 4.

Observation

Deciding whether or not to apply the practical expedient to 'grandfather' the lease definition on transition is crucial, as it impacts the scope and nature of work to be completed. For mining companies, some contracts currently accounted for as leases may not be leases under IFRS 16 (refer section 1.3), and some contracts not currently leases may become leases applying the requirements of IFRS 16 (refer section 1.1.3).

For more information about the requirements of IFRS 16 *Leases*, refer to related KPMG resources on page 47.

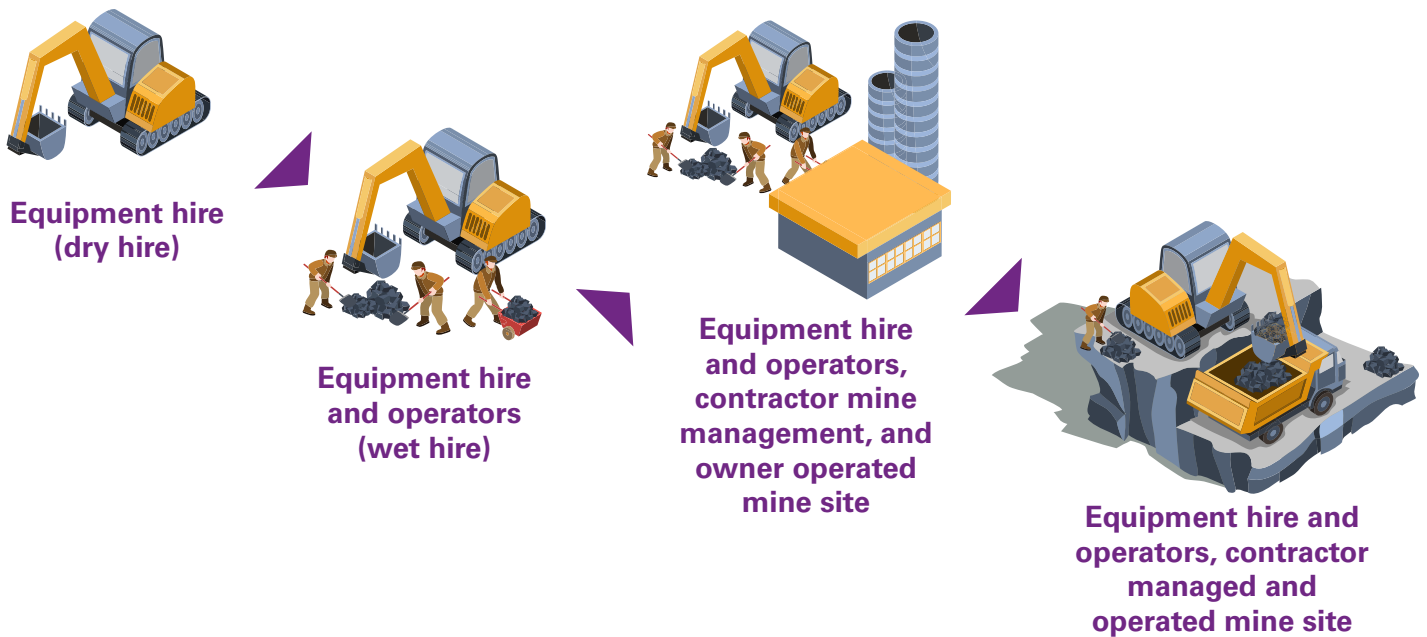
Case study

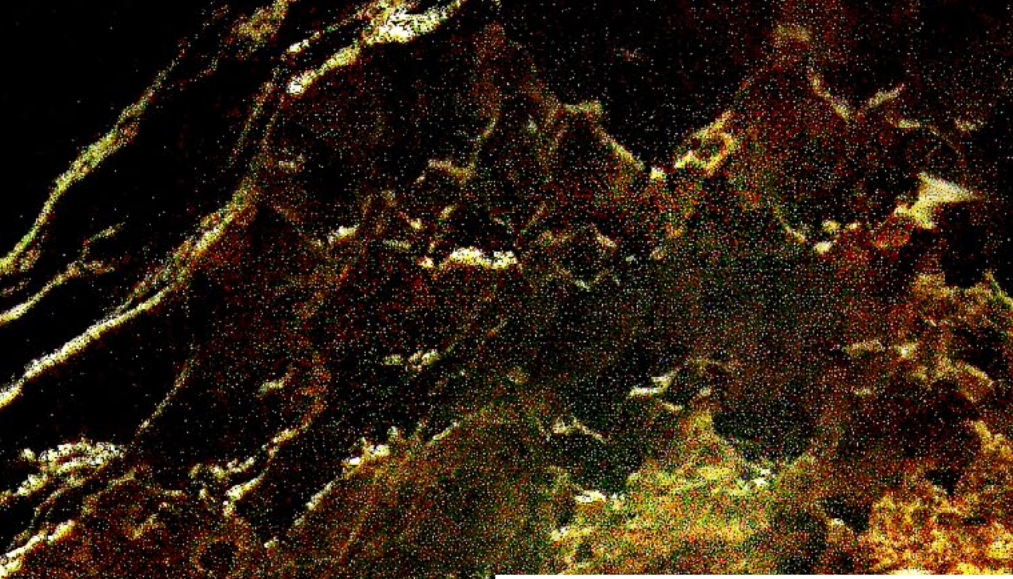
Mining Services contract

Mining services contracts range from equipment hire, to full scale management of mining operations. Where contracts include the use of equipment, companies will need to assess whether the contract is, or contains a lease or multiple leases.

Whether the customer controls the equipment will be a key judgement in applying the IFRS 16 lease definition.

The facts and circumstances specific to each contract are required to be considered in identifying whether a contract contains a lease. The following case study explores some of the key judgements and decisions in identifying leases in a mining services contract.





Scenario background

An iron ore miner (miner) enters into a 5 year contract with a mining contractor (contractor) to complete truck and shovel mining of specific blocks at the miner's site. The contract does not list the equipment to be used.

The contractor is responsible for providing a fleet of equipment and operators suitable to meet the requirements of the miner's mine plan. The equipment required will vary throughout the contract as the requirements of the mine plan change. The contractor can remove equipment from site and bring additional items of equipment to site as long as continuous delivery of product to the crusher is uninterrupted.

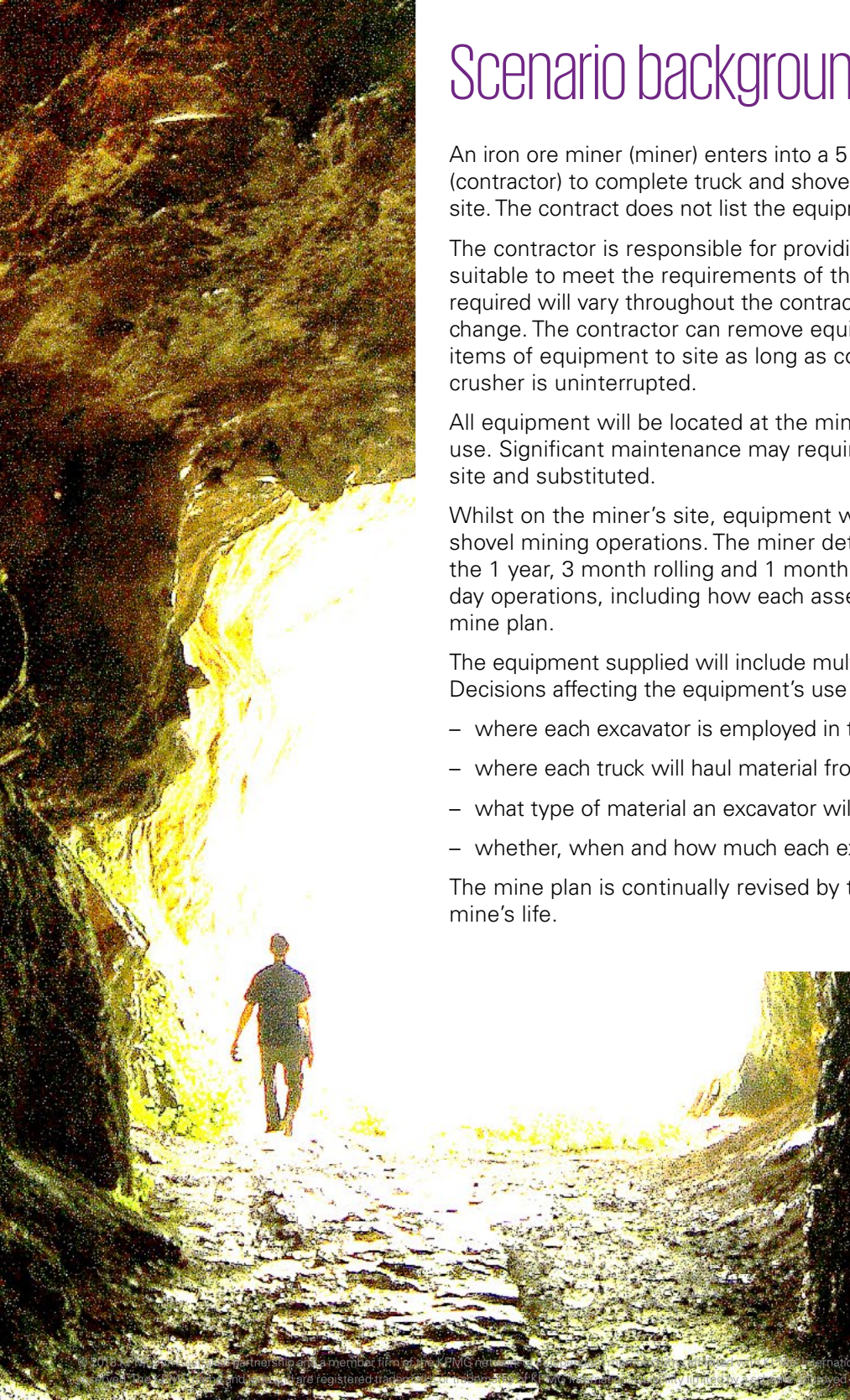
All equipment will be located at the miner's site throughout the period of use. Significant maintenance may require equipment to be removed from site and substituted.

Whilst on the miner's site, equipment will be exclusively used for the truck and shovel mining operations. The miner determines the Life of Mine Plan (LOMP), the 1 year, 3 month rolling and 1 month mine plan and supervises the day-to-day operations, including how each asset will be employed to comply with the mine plan.

The equipment supplied will include multiple excavators and haulage trucks. Decisions affecting the equipment's use include:

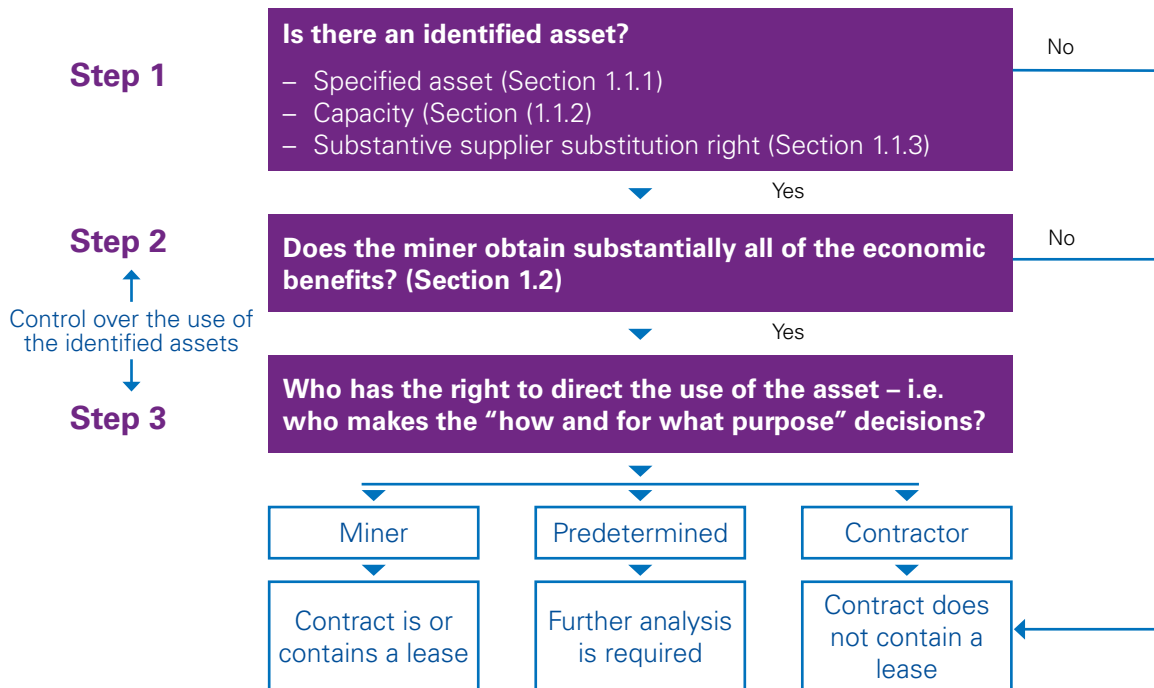
- where each excavator is employed in the pit
- where each truck will haul material from and to
- what type of material an excavator will dig, and a truck will haul
- whether, when and how much each excavator and truck is used.

The mine plan is continually revised by the miner over the course of the mine's life.



1 Lease definition

For the purposes of this case study, the assets made available for use by the contractor comprise trucks and shovels (excavators).



Step 1

Lease definition assessment	Observation
Is there an identified asset?	
<p>Is there a specified asset?</p> <ul style="list-style-type: none"> – Whilst specific items of equipment are not listed in the contract, it appears that the contract is dependent on the use of specific equipment. Each item of equipment becomes a specified asset once made available for use. 	<ul style="list-style-type: none"> – An asset does not need to be specified at contract inception, but can be specified at the time it is made available for use (Section 1.1.1). – When a contract depends on the use of a specific asset, once an asset is made available for use, it becomes specified (Section 1.1.1).
Does the contractor have substantive substitution rights?	
<ul style="list-style-type: none"> – In this case, the miner cannot prevent the contractor from substituting equipment, however the miner does not know that: <ul style="list-style-type: none"> – it will be practical e.g. whether alternative assets will be available throughout the period of use; nor whether – it will be economically beneficial, the equipment are located at the miner’s site, and costs will be incurred by the contractor to substitute. – A right to substitute for repairs or maintenance is not considered. – Based on the facts and circumstances available, the miner is not able to readily determine that the contractor’s substitution right is substantive. 	<ul style="list-style-type: none"> – Where assets are located at the miner’s site, it is likely that the costs associated with substitution will exceed the benefit from substitution (Section 1.1.3). – The right to substitute for repairs and maintenance is not considered in assessing whether there is a substantive right to substitute (Section 1.1.3). – Unless the miner is able to readily determine that there is a practical ability to substitute and the benefits from substitution will outweigh the costs, the contractor’s substitution right is not substantive (Section 1.1.3).

The equipment made available for use by the contractor are identified assets.

Step 2

Lease definition assessment	Observation
Does the miner obtain substantially all of the economic benefits?	
<ul style="list-style-type: none"> – Throughout the period of use, the equipment will be used exclusively to perform the scope of works under the contract and are not permitted to be used for any other purpose. 	<ul style="list-style-type: none"> – Where a miner has exclusive use of the assets, assessing whether the miner obtains substantially all of the economic benefit will be straight forward (Section 1.2).

The miner obtains substantially all of the economic benefits from use of the assets.

Step 3

Lease definition assessment	Observation
Who has the right to direct the use of the asset?	
<p>Based on the facts and circumstances specific to this scenario, it appears that the decisions which are made during the period an asset is used include:</p> <ul style="list-style-type: none"> – where each excavator is employed in the pit – where each truck will haul material from and to – what each excavator will dig and truck will haul – when, whether, and how much each excavator and truck is used. <p>The miner sets the mine plans, effectively providing instructions which determine the quantity and timing of delivery of the output. In addition, the daily operations of the mine are supervised by the miner and each of the above decisions are made by the miner.</p> <p>Therefore the miner has the right to determine where, when, whether and how much output the equipment will produce throughout the period of use.</p> <p>The contractor, in contrast, has no rights to decide (or change), or prevent the miner from changing how the excavators and trucks are used. The contractor has no right to change where, whether or when, or how an identified asset will be used.</p>	<p>A miner needs to have the right to make the most relevant decisions during the period of use in order to direct the use of the asset, unless the relevant decisions are predetermined and the miner either operates or designed the asset (section 1.3).</p> <p>Examples of relevant decisions that, depending on the circumstances, grant the right to change how and for what purpose the asset is used include the following:</p> <ul style="list-style-type: none"> – What: Rights to change the type of output that is produced by the asset – When: Rights to change when the output is produced – Where: Rights to change where the output is produced – Whether and how much: Rights to change whether the output is produced, and the quantity of that output (section 1.3).
<p><i>In this case, it appears that the most relevant decisions are made by the miner and the miner directs the use of the identified assets, being the trucks and excavators.</i></p>	

Observation

The conclusion that a lease exists over the trucks and excavators under the contract in the case study is based on the specific facts and circumstances of the scenario presented.

Mining services arrangements vary from contract to contract in how they operate and the decisions which the miner and contractor each have the right to make. Identifying whether an arrangement contains a lease, or multiple leases, may be a significant area of judgment and will depend on the specific facts and circumstances of the arrangement. The conclusions reached may be different for each contract.

Some of the areas in the lease identification assessment which may require careful consideration include:

1. Whether the contractor has a substantive substitution right (Section 1.1.3)

- The assessment of whether it is practical and economically beneficial for the contractor to substitute an asset throughout the period of use is performed by the miner from the contractor’s perspective. The miner may not have access to sufficient information to determine whether the contractor’s substitution right is substantive. If the miner is not able to readily determine whether the contractor has a substantive substitution right, the miner shall presume that the substitution right is not substantive.

2. Who directs the use of the asset or asset (Section 1.3)

- There may be multiple decision-making rights which can change how and for what purpose an asset is used. Under some arrangements, both the miner and contractor may be granted these decision-making rights. Significant judgment may be required in these types of scenarios, including careful consideration of which decisions each party controls and which of those decisions are most relevant – i.e. most significantly affect the economic benefits that can be derived from use of the asset.

2 Lease and non-lease components

A mix of equipment is required to fulfil the contract, including trucks and excavators. It is concluded that the lease of each truck and excavator are each separate lease components, this is because:

- the miner can benefit from use of each of the pieces of equipment on their own
- although the miner is leasing all pieces of equipment for one purpose (i.e. to engage in mining activities), the equipment can be used independently of other items.

In addition to the lease of equipment, the contract includes a fixed labour component. The wage component of the contract relates to services, that is a non-lease component.

As a practical expedient, the lessee can elect to apply lease accounting to the entire contract.

Contract price: A fixed annual amount of \$1,000,000 relating to wage costs is payable annually, plus a variable amount relating to the equipment payable based on tonnes mined, expected to be approximately \$1,500,000 per annum. Initial direct costs, comprising legal costs associated with the origination of the lease agreement total \$15,000.

3 Lessee accounting

Initial recognition

Lease liability

Given the payments for use of the leased assets are fully variable and would not be included in the lease liability, for the purposes of illustrating lease accounting applying the requirements of IFRS 16, the remainder of this example assumes the practical expedient is applied.

Payments for equipment rental are fully variable, payable based on tonnes mined. Variable lease payments which are not linked to an index or rate are not allocated to the lease liability and there is no lease liability to recognise on balance sheet.

Only in the event the lessee applies the practical expedient to not separate lease and non-lease components would a lease liability be recognised. Assuming this practical expedient is applied, payments for non-lease component (\$5,000,000 = \$1,000,000 × 5 years) would be included within the lease liability. Using a discount rate of 5%, the lease liability is calculated as \$4,329,477. If the practical expedient is not applied, the lease liability would be nil.

ROU asset

The total of the lease liability of \$4,329,477 and initial direct costs of \$15,000 equals \$4,344,477, being the ROU asset at initial recognition

Observation

Lessees can choose either to present ROU assets separately from other assets on the face of the balance sheet or within the same line item as that within which the corresponding asset would be presented if they were owned.

Case study

Presentation

The impact on the balance sheet, income statement and EBITDA throughout the lease are illustrated below.

IFRS 16	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Lease liability	4,329,477	3,545,951	2,723,248	1,859,410	952,381		
Right of use asset	4,344,477	3,475,581	2,606,686	1,737,791	868,895		
Operating expense (variable)*		1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	7,500,000
Depreciation		868,895	868,895	868,895	868,895	868,895	4,344,477
Interest expense		216,474	177,298	136,162	92,971	47,619	670,523
Net PBT impact		2,585,369	2,546,193	2,505,058	2,461,866	2,416,514	12,515,000
EBITDA impact		1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	7,500,000

Assumptions:

* Variable lease payments are \$1,500,000 per annum.

IFRS 16 vs IAS 17

Under IAS 17, operating leases are accounted for as operating expenses on a straight-line basis. Amortisation of the lease liability and depreciation of the ROU asset under IFRS 16 will result in the front loading of lease related expenses in the income statement.

The table below illustrates how the mining services arrangement may have been accounted for under applying the requirements of IAS 17.

IAS 17	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Lease liability	-	-	-	-	-	-	
Right of use asset	-	-	-	-	-	-	
Operating expense (variable)*		2,515,000	2,500,000	2,500,000	2,500,000	2,500,000	12,515,000
Depreciation	-	-	-	-	-	-	
Interest expense	-	-	-	-	-	-	
Net PBT impact		2,515,000	2,500,000	2,500,000	2,500,000	2,500,000	12,515,000
EBITDA impact		2,515,000	2,500,000	2,500,000	2,500,000	2,500,000	12,515,000

Assumptions:

The lease of equipment was either an operating lease or services contract applying the requirements of IAS 17/ IFRIC 4 (the accounting aligned in either case) and services were accounted for on accruals basis.

* Variable lease payments are \$1,500,000 per annum.

Similarly, the presentation of the cash flow statement will change upon transition to IFRS 16. Operating lease expenses were previously included within cash flows from operating activities, and lease payments under IFRS 16 are classified as a cash flow from financing activities.

Next steps and other resources

What are the key steps in preparing for transition to IFRS 16?

Step 1

Preparation

Team: Identify the working group that will lead the project, considering both the finance team, and contracts management / procurement and operational teams

Timing: Allow sufficient time to collate data/contracts, interpret, consult and develop solutions

Impact assessment: Plan an assessment to identify the potential impact of IFRS 16, set the scope of the contracts to review, allocate tasks and engage with appropriate stakeholders

Step 2

Contracts

Catalogue your contracts: Current lease schedule is the ideal starting point as it will document what you already know. Importantly due to the revised definition of what may constitute a lease, its important to review other contracts that may include a lease

Assess which contracts contain leases under IFRS 16: Once you have a full register of contracts set a scope and review those that may contain leases

Step 3

Accounting impacts

Select transition method: Key decisions include whether to grandfather and practical expedients

Calculate lease accounting entries: Develop or update company lease calculation model, or consider software solution for more complex lease portfolios, calculate discount rates, consider lease term and options to extend

Metrics: Calculate estimated impacts on key internal (management KPIs) and external metrics (bank covenants), including those impacted by operating costs, depreciation, finance cost. Engage with key stakeholders that may be impacted early

Policies and disclosures: Update accounting policies and note disclosures in financial statements

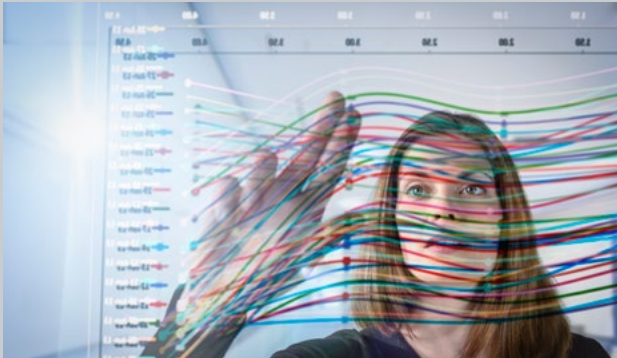
Step 4

Business as usual

Future contract negotiations: Ensure that all the relevant business stakeholders understand the key elements of IFRS 16 so that future contracts are structured in appropriate manner to meet business needs and accounting implications are known

Month end processes: Update internal processes to record contracts, calculate lease liabilities and right of use assets, update financial statement disclosures templates and KPI calculations

KPMG Tips & Project Tools



A **KPMG training** session tailored to your business and staff needs can provide an efficient and valuable opportunity to up-skill your team and reduce disruption.

2. Implementation considerations

We have reviewed characteristics of [the Company's] lease portfolio made up of (hundreds, thousands) of types (e.g., real estate, vehicle, technology, equipment, other) assets to identify potential implementation complexity given AASB 16's recognition and measurement requirements. The higher the complexity, the more time, effort and cost likely to be incurred to address the issue. Below we highlight key areas of focus for management with respect to implementation of AASB 16.

Complexity rating	Changeover
FRGH	The issue is highly relevant to the company's lease portfolio and is critical to the proper execution of AASB 16. It will require significant attention from management.
MHSD	The issue is relevant to the company's lease portfolio and is important to the proper execution of the AASB 16. It will require attention from management.
LCSD	The issue is a gap when comparing the AASB 117 and AASB 16. It will require action from management, but can be addressed in a short time frame.

Overall complexity rating	Category	Decision
FRGH	Identification of embedded leases in service contracts	3.1
FRGH	Measurement of the lease liability and ROU asset	2.2
MHSD	Application of transition options and practical expedients	2.3
MHSD	Complexity of lease transactions	2.4
FRGH	Lease data collection	2.5

Our views on implementation complexities with respect to AASB 16 are based solely on discussions with management.

© 2017 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Liability limited by a scheme approved under Professional Standards Legislation.

KPMG Leases Questionnaire - Lease and Embedded Lease Analysis

Subject Matter: Direct subject matter
 To: Name, ex Audit Risk Management and Compliance Committee
 Submitted By: Name, FIRM
 Submitted date: Date
 Approved date: Date

Overview
 Purpose: The purpose of the lease analysis is to identify all leases and embedded leases and determine the proper accounting under AASB 16. At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. This will ensure that all of the lease information has been captured from a completeness and accuracy perspective. It is intended to be used as part of the lease accounting change assessment.

Instructions
 Questions are grouped by the following sections:
 Scope - determining whether the arrangement is scoped out of AASB 16 Leases
 Identified Asset - determining if there is a specified asset where the supplier does not have the substantive substitution right
 Economic benefit - determining whether the customer (i.e. user) obtains substantially all the economic benefits from use of the asset
 Control the use - determining whether the customer has the right to direct the use of the asset (i.e. how and for what purpose the asset is used)

- Please answer all questions in order that are applicable to your business unit as in the 'Responses' column
 - Please respond to the questions in the 'Responses' column using the drop down menu
 - Please aim to answer all questions and provide as much relevant information. For each question there is the option to add 'Notes'. Please add comments where it will assist us in understanding the entity's lease portfolio and/or implications of applying AASB 16.
 - If an answer is unknown at this stage, then select 'Unknown'

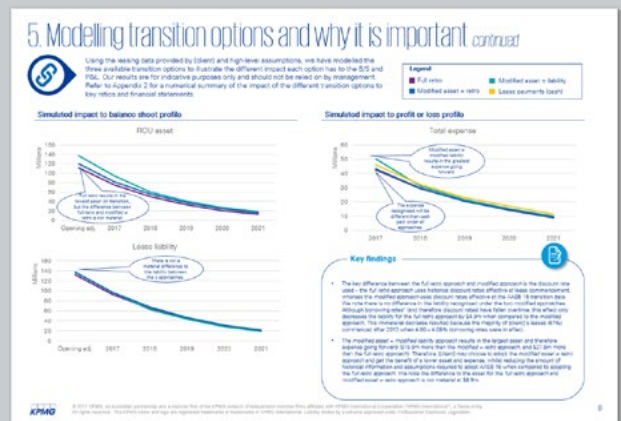
Background: Direct background
 Relevant literature: AASB 16 Leases
 Contact: If you have questions, please contact [contact_name] at [contact_email]

All further questions are with reference to the entity Question as a LES/LES

Question	What this means
1. Is the lease to explore for minerals, oil, natural gas and similar non-regenerative resources?	Account for in accordance with AASB 16 (application for production of Mineral Reserves)

KPMG's embedded lease contract review checklist is a tool that can guide you through key contract terms to consider that may indicate an embedded lease where assets are used to deliver a service

KPMG's impact assessment checklist is a straight forward resource that allows you to kick start your project efficiently and focus on key risks.



Model out the impact of the new standard on key metrics, including liabilities, assets and profit **to assist in communication** of impact internally and externally

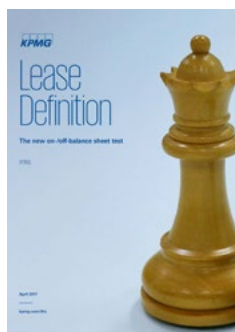
Other KPMG resources

We have a suite of publications to support you in the move to IFRS 16 *Leases*. Detailed information on practical application issues associated with the new standard is contained within the following publications:

Technical accounting publications:



First impressions



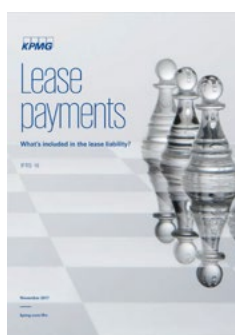
Lease Definition



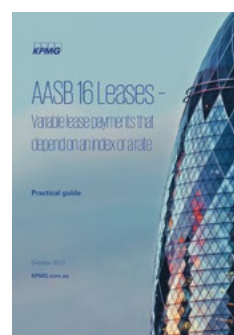
Leases Transition Options



Leases Discount rates

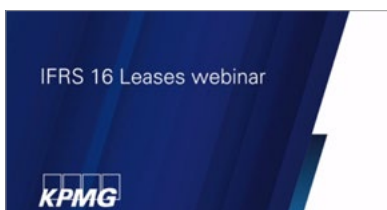


Lease payments

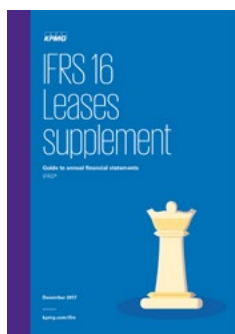


Variable lease payments that depend on an index or a rate

Other resources:



On demand technical accounting webinars



Illustrative disclosures supplement



KPMG Global Mining Institute: Our hub for mining industry insights and global contacts

Contact us

If you would like to discuss any of the content of this publication, please get in touch with any of us below or your local KPMG contact.

KPMG Australia Mining contacts:

Western Australia

Denise McComish
National Mining Leader
T: +61 8 9263 7183
E: dmccomish@kpmg.com.au

Rob Gambitta
Partner
T: +61 8 9263 7451
E: rgambitta@kpmg.com.au

Glenn Diedrich
Senior Manager
T: +61 8 9278 2032
E: gdiedrich@kpmg.com.au

Hayley Pang
Manager
T: +61 8 9263 4818
E: hpang1@kpmg.com.au

Victoria

James Dent
Partner
T: +61 3 9838 4560
E: jdent@kpmg.com.au

Glenn Austin
Director
T: +61 3 9838 4107
E: glennaustin@kpmg.com.au

New South Wales

Daniel Camilleri
Partner
T: +61 2 9335 8101
E: dcamilleri@kpmg.com.au

Queensland

Jason Adams
Partner
T: +61 7 3233 9642
E: jfadams@kpmg.com.au

Simon Crane
Partner
T: +61 7 3233 3153
E: simoncrane@kpmg.com.au

KPMG.com.au

The information contained in this document is of a general nature and is not intended to address the objectives, financial situation or needs of any particular individual or entity. It is provided for information purposes only and does not constitute, nor should it be regarded in any manner whatsoever, as advice and is not intended to influence a person in making a decision, including, if applicable, in relation to any financial product or an interest in a financial product. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

To the extent permissible by law, KPMG and its associated entities shall not be liable for any errors, omissions, defects or misrepresentations in the information or for any loss or damage suffered by persons who use or rely on such information (including for reasons of negligence, negligent misstatement or otherwise).

© 2018 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo and are registered trademarks or trademarks of KPMG International.

Liability limited by a scheme approved under Professional Standards Legislation.

February 2018. N16331ARC.