

Point of view

Mining sector – IFRS 15, the new revenue Standard could impact profile of revenue and profit recognition



In a nutshell

- The **profile of revenue and profit recognition** may change for certain mining companies as the new revenue Standard is more detailed and more prescriptive than the existing guidance and introduces new complexities. In particular, mining companies will need to consider:
 - whether the new ‘control’ model will change the timing of revenue recognition. It is expected that **FOB and CIF sales** will continue to be recognised when the goods pass over the ship’s rail, but consideration will need to be given as to whether revenue recognition under certain **smelting/refining arrangements**, involving sale of ore and repurchase of metal, will change in light of the new guidance on sale and repurchase agreements;
 - whether freight revenue will need to be accounted for separately if control of goods passes before final delivery;
 - the impact of new guidance where pricing mechanisms include **variable consideration**. As discussed below, it is not yet clear whether this may change the accounting for **provisionally priced sales**;
 - the extent to which arrangements with collaborators or partners, which might include **royalty funding arrangements**, fall within the scope of the new Standard;
 - whether revenue must be adjusted for the effects of the **time value of money**; and
 - the appropriate accounting for **exchanges of inventory**.
- The new Standard requires significantly **more disclosures** relating to revenue and entities will need to ensure that **appropriate processes** are in place to gather the information.

What’s happened?

The International Accounting Standards Board (IASB) has published a new Standard, IFRS 15 *Revenue from Contracts with Customers* (‘the new Standard’). This is subject to EU endorsement. The new Standard outlines a single comprehensive model of accounting for revenue arising from contracts with customers and supersedes current revenue recognition guidance, which is found currently across several Standards and Interpretations within IFRSs. The core principle is that an entity recognises revenue to reflect the transfer of goods or services, measured at the amount to which the entity expects to be entitled in exchange for those goods or services.

The new Standard is effective for reporting periods beginning on or after 1 January 2018, with earlier application permitted. Entities can choose to apply the Standard retrospectively or use a modified approach in the year of application. IFRS and US GAAP are now almost fully converged on revenue recognition with the most significant differences relating to interim disclosures and timing of adoption. Prior to adoption, entities will need to consider carefully the requirement to disclose the potential impact of the new Standard, which is a key area of focus for regulators.

Implications for the Mining sector

Below, we highlight certain key impacts resulting from the new Standard that may be of particular interest to those in the mining sector. Of course many more complexities exist and, as described below, Deloitte is producing further guidance which explores these in greater detail.

Whereas previously IFRSs allowed significant room for judgement in devising and applying revenue recognition policies and practices, IFRS 15 is more prescriptive in many areas relevant to the mining sector. It also introduces some new concepts for determining when revenue should be recognised.

What are the most significant changes?

Will the new control model impact the timing of revenue recognition?

Under IAS 18, the timing of revenue recognition from the sale of goods is based primarily on the transfer of risks and rewards. IFRS 15 instead focuses on when control of those goods has transferred to the customer. Although the timing of transfer under the two models will often coincide, this different approach may result in a change of timing for revenue recognition for some entities. Entities will need to consider whether this could change the treatment of any consignment stocks, and also whether any shipping arrangements may be affected.

Sales contracts in the mining sector commonly refer to the INCO terms, with FOB (Free on Board) and CIF (Carriage, Insurance and Freight) being two of the most common types. Under FOB sales, legal title transfers when the goods pass over the ship's rail and the customer is responsible for freight and insurance. Similarly, under CIF sales, legal title transfers when the goods pass over the ship's rail but here the seller will arrange the freight and insurance on behalf of the customer although the customer is the named counter-party and would be the entity to seek redress in the event of a claim.

Under IAS 18, revenue is typically recognised on both FOB and CIF contracts once the goods are on board, reflecting the substantial transfer of risks and rewards at that point. This revenue recognition point is typically also followed for provisionally priced concentrate sales, where price risk is retained by the seller for a specified quotation period as described above. By contrast under certain sales contracts, title is retained until the goods are received at the destination port and the seller retains the freight performance and insurance risk whilst the goods are in transit. Accordingly revenue on these contracts is typically recognised later, at arrival at the destination port.

The change to a 'control' basis from a 'risks and rewards' approach is not expected to change the above analysis but an additional significant aspect of a control based analysis would be the ability to resell the goods in the seaborne trading markets or amend a contract to change the destination of the goods in transit, both of which may lead to the entity recognising revenue at a later date because it still has control of the goods during the transit period.

Where an entity has concluded that it is appropriate for the revenue from the sale of goods to be recognised at the point those goods are loaded onto the ship in a CIF contract, it will need to consider whether, if the amounts are material, it may be necessary to allocate part of the transaction price to a distinct "shipping and insurance" service, with that element of revenue recognised potentially later when or as that service is provided.

At the time of writing, the FASB have tentatively decided to amend the US standard to allow shipping services to be accounted for as a fulfilment cost (i.e. providing for costs instead of deferring revenue), but the IASB is not proposing a similar expedient.

When should variable or uncertain revenues be recognised and how might this affect provisionally priced sales?

Sales contracts in the mining sector can include significant variable elements that are only finalised a number of months after shipment to the customer. There are new specific requirements in respect of variable consideration such that it is only included in the transaction price if it is highly probable that the amount of revenue recognised would not be subject to significant future reversals when the uncertainty is resolved. However, at this stage, the intended interaction between these new requirements and the requirements of the IFRSs dealing with financial instruments is unclear.

An example of uncertain revenues arises in the context of provisionally priced sales, where the pricing at the time of shipment is determined provisionally and later adjusted based on a prevailing index price at a specified future date (or over a specified future period).

At present, provisional pricing features are typically accounted for as 'embedded derivatives' in accordance with applicable guidance on accounting for financial instruments (IAS 39), such that the open contracts are fair valued, typically using the forward curve for that commodity. As a consequence, revenue is currently recognised at an unrestricted amount at the point of shipment, even though there is a reasonable possibility that the amount ultimately invoiced may be lower. This methodology is understood by mining companies and generally where the provisionally priced fair value gain/loss is significant, detailed disclosure is given in the financial statements.

However, the IASB has recently issued new financial instruments guidance (IFRS 9), which changes the approach taken to embedded derivatives in certain respects.

From a mining company's perspective, given the risk that post sales commodity price swings could reverse revenue recognised under the current accounting guidance, application of the new variable consideration guidance would require an estimate of how much of the consideration would be highly probable not to reverse. This would clearly be a subjective estimate on a company-by-company basis, and might also be a confusing approach for users of the financial statements. Moreover, many mining companies will have economic hedges in place that will naturally offset subsequent price movements; if application of the variable consideration guidance is required, such companies will need to formally designate hedges in order to avoid reflecting price volatility that is not economically present.

We have discussed these issues with staff of the IASB, and it is hoped that greater clarity will be provided over the intended interaction of IFRS 9 and IFRS 15. Accordingly, developments at the IASB should continue to be monitored.

When does control transfer and revenue recognition take place under tolling arrangements?

Tolling arrangements take many forms and can be complex in their structure. For example:

- The substance of the commercial terms can be that the transfer of the goods to the toll refiner/smelter is a sale by the miner.
- In some cases, the miner retains title to the goods during the toll processing, for which a fee is paid, and the mining entity only recognises a sale when the finished goods are transferred to a final customer. (This type of arrangement can sometimes be structured as a formal tolling arrangement where title is retained or as a sale and repurchase once the processing is complete.)
- In other cases, the toll refiner/smelter automatically purchases the product once processed and revenue is often recognised at that point.

The introduction of a control approach may result in a change to revenue recognition for some entities. In particular, IFRS 15 includes new guidance on accounting for repurchase agreements, including scenarios when those goods will or may be repurchased as part of another asset and when goods that are substantially the same as those supplied will or may be repurchased.

IFRS 15 also includes guidance on how to account for non-cash consideration. The toll refiner will typically make an economic return by charging a unit cost but it will also usually retain any metal recoveries above a contractual threshold and may also retain certain by-products for no consideration. Under IFRS 15, a value may need to be assigned to the sales and costs for such non-cash consideration, noting that in many cases the true value will not be known until after the processing is complete.

Are collaborative arrangements, including royalty and offtake funding, in the scope of the new Standard?

It is not uncommon in the mining sector for two separate entities to combine their resources and collaborate in the operation of a mine. Where these collaborations are in the form of a joint venture or a joint operation, they will continue to be governed by IFRS 11 *Joint Arrangements*. In some other arrangements, though, an economic interest in a mine or future production is sold under a royalty or a metal streaming agreement. These take many forms but commonly funds are received up front in exchange for a percentage of physical production (known as streaming); a percentage of revenues or profits; or as a prepayment against future sales for which the pricing may be fixed or index linked.

A mining entity will have to assess whether the royalty recipient/investor/buyer in the streaming arrangement is its customer in order to establish whether transactions with that entity are within the scope of the new Standard. The new Standard introduces new specific guidance on this topic, and this may result in some arrangements that have not previously been regarded as revenue transactions nevertheless falling within the scope of the new Standard. It may also result in some arrangements which have previously been treated as revenue transactions being outside of the scope of the new Standard and entities will need to consider in these cases whether it is still appropriate to apply the new Standard by analogy.

At present, and depending on the specific facts and circumstances, the royalty or streaming arrangement may be accounted for as a prepayment for goods to be supplied in the future (i.e. deferred revenue), a partial disposal of an existing asset (i.e. a reduction in property, plant and equipment or intangibles) or a financial liability to be accounted for under IFRS 9 (or, for entities that have not adopted IFRS 9, IAS 39). Following the introduction of IFRS 15, entities will need to evaluate whether any changes are required to the current approach. The treatment adopted may have a significant impact on the recognition of revenue/income and profit, and potentially financing expense, as discussed further below.

Should revenue be adjusted for the effects of the time value of money?

IFRS 15 introduces new and more extensive guidance on financing arrangements and the impact of the time value of money. Sales by entities in the mining sector may include financing arrangements in that the timing of cash inflows from the customer may not correspond with the timing of recognition of revenue. Under the new Standard, the financing component, if it is significant, is accounted for separately from revenue. This applies to payments in advance as well as in arrears, but subject to an exemption where the period between payment and transfer of goods or services will be less than one year.

For example, in the above royalty and metal streaming situations, if the initial amounts received from the customer are treated as a prepayment for goods to be supplied in the future, consideration will need to be given as to whether a financing expense will need to be recognised on the amount prepaid, with the revenue ultimately recognised on transfer of the goods being grossed up by the financing element.

Are exchanges of inventory within the scope of the new Standard?

The current revenue guidance specifically scopes out exchanges of goods or services of a similar nature and value. The new Standard takes a slightly different approach, scoping out non-monetary exchanges between entities in the same line of business to facilitate sales to customers, or to potential customers, other than the parties to the exchange. Entities in the mining sector may on occasion swap inventories with other entities, for example as part of a blending transaction. Such entities will need to consider whether counterparties to such non-monetary exchanges should or should not be regarded as in the same line of business and whether the different scoping requirements will change any of their current practices. For example, as the scope exclusion is no longer restricted to goods that are “similar in nature and value”, an exchange of dissimilar goods may no longer result in revenue being recognised if the contracting parties are in the same line of business and the purpose of the exchange is to facilitate sales to customers. It will also be important to keep in mind the new guidance on repurchasing goods, as discussed earlier.

How might this affect you?

The timing of revenue and profit recognition may be significantly affected by the new Standard

Applying these new rules may result in significant changes to the profile of revenue and, in some cases, cost recognition. This is not merely a financial reporting issue. As well as preparing the market and educating analysts on the impact of the new Standard, entities will need to consider wider implications. Amongst others, these might include:

- changes to **key performance indicators** and other key metrics;
- changes to the **profile of tax cash payments**;
- availability of **profits for distribution**;
- for **compensation and bonus plans**, impact on the timing of targets being achieved and the likelihood of targets being met; and
- potential non-compliance with **loan covenants**.

Current accounting processes may require changes to cope with the new Standard

As explained above, IFRS 15 introduces new requirements to move to a more conceptual approach. The complexity of applying this approach and of producing the detailed disclosures required by the new Standard in the mining sector may require modifications to existing accounting processes. Entities should ensure they allow sufficient time to develop and implement any required modifications to processes.

What else might change?

In addition to the key changes discussed above, the new Standard introduces detailed guidance in many areas regarding the reporting of revenue and entities will need to ensure that they have considered all of these when assessing the extent to which their accounting policy for revenue may need to be amended.

More detailed information on the impact of IFRS 15 can be found in Deloitte’s **Need to know** publication available from www.ukaccountingplus.com. Further industry publications are also available **here**.

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