VIEWPOINTS:
Applying IFRS® Standards in the Mining Industry

IMPACT OF IFRS 15, *REVENUE FROM CONTRACTS WITH CUSTOMERS*

DECEMBER 2018

Mining Industry Task Force on IFRS® Standards

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

Disclaimer: The views expressed in this series are non-authoritative and have not been formally endorsed by CPA Canada, PDAC or the organizations represented by the Task Force members and do not represent the views of the Canadian Accounting Standards Board (AcSB). CPA Canada does not accept any responsibility or liability that might occur directly or indirectly as a consequence of the use, application or reliance on this material.

The information included in this publication is for general information purposes only and should not be used as a substitute for consultation with professional advisors.

Background

The core principle under IFRS 15, *Revenue from Contracts with Customers*, is that an entity recognizes revenue to depict the transfer of promised goods or services to a customer at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The concept of transfer is based on control as opposed to risks and rewards. Under IFRS 15, control is defined as the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control also includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

The identification of customers and the determination of the performance obligations have important consequences for an entity's revenue analysis. These steps provide a foundation for determining when control transfers and, consequently, when revenue is recognized.

CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

PROSPECTORS & DEVELOPERS ASSOCIATION OF CANADA

Revenue is recognized only when the identified performance obligation (i.e., the promise to transfer a distinct good or service to a customer) is satisfied by transferring the promised good or service to the customer. A good or service is transferred when the customer obtains control of that good or service.

Issue

IFRS 15 contains or refines several concepts applicable to contracts common in the mining industry. From the production of an unrefined commodity, through refining, transportation, and eventual delivery, a mining entity applying IFRS 15 must be acutely aware of who its customer is (e.g., an intermediary entity, such as a refinery, or the ultimate customer), what constitutes part of its obligation to its customer, what consideration it is entitled to receive, and how and when that obligation is satisfied (i.e., when does control pass to the customer).

This Viewpoint highlights the following practical challenges in applying the standard:

1. **Understanding the arrangement and identifying customer(s):** How should a mining entity evaluate who its customer is?
2. **Shipping and refining obligations:** How should obligations associated with shipping a commodity to a customer, or providing refining services, be treated?
3. **Transfer of control over commodities:** How does a mining entity evaluate transfer of control for a commodity and the resulting revenue recognition?
4. **Provisional Pricing:** How should a mining entity address the unique pricing issues associated with provisionally priced contracts?

Mining companies have also encountered a number of other issues associated with applying IFRS 15, which are beyond the scope of this *Viewpoint*. These issues include but are not limited to:

- scope: whether certain contracts, such as production-sharing contracts, inventory exchanges, repurchase agreements, cashflows from purchased royalties, cashflows from royalties received in exchange for mineral interests, and disposals of exploration and evaluation assets are within the scope of, or affected by, IFRS 15
- evaluating significant financing components in alternative financing arrangements determined to fall within the scope of IFRS 15
- accounting for bill-and-hold arrangements; and
- assessing the impact on take-or-pay and other similar long-term contracts.

Viewpoints

Understanding the arrangement and identifying customer(s): How should a mining entity evaluate who its customer is?

A mining entity may promise to provide or, alternatively may promise to arrange for someone else to provide, a good (e.g., a mineral commodity) or a service (e.g., refining services or shipping services for the mineral commodity). These arrangements necessitate the determination of who the mining entity's customer is for its mineral commodity. Where it is not evident whether a good or service is controlled by the mining entity before it is provided to a customer, the entity will need to consider indicators of whether it is acting as the principal (i.e., when it is primarily responsible for fulfilling the overall "promise"), whether it has inventory risk and whether it has discretion for establishing the price of a good or service.

Example

Assumptions

- A gold mining entity (MineCo) produces unrefined gold bars with a gold content that is below gold bullion standards required for commercial gold sales with a customer.
- It ships the unrefined gold bars to a third party refining entity (Refinery) to conduct refining services.
- The refining contract stipulates that MineCo will deliver unrefined gold bars and the Refinery will outturn gold bullion. In this instance, the specific terms of the contract further stipulate that, while the physical gold is in the possession of the Refinery once delivered to the Refinery, the Refinery never takes legal title to either the unrefined or refined gold contained within the originally delivered unrefined gold bars and MineCo retains the right to direct the eventual outturned gold bullion to a customer.[1]
- MineCo enters into a separate sales contract with a commercial bank (Bank) to sell the gold bullion once refining activities have been completed,[2] based on prices agreed upon between MineCo and the Bank. To the extent the refined gold bullion does not meet the Bank's specifications, the Bank has recourse against MineCo pursuant to the terms of the contract.

1 Note that in some arrangements, the agreement between the mining entity and the refiner may permit the mining entity to sell the refined gold directly to the refinery instead of the bank. Under such circumstances, the refiner is the mining company's customer.

2 MineCo could also have entered into a contract to sell a specified quantity of gold within the unrefined gold bars to a customer. While this would not impact the determination of the ultimate customer, it could impact the point at which control transfers.

MineCo needs to determine, through a careful review of contract terms, who its customer is (i.e., whether it is the Refinery or the Bank). For MineCo, this determination will impact the timing of the transfer of control, revenue recognition and presentation of revenue, and cost of goods sold (i.e., the refining costs that would be incurred by MineCo if the Bank were considered to be the customer).

In this simplified example, MineCo concluded that the contract represents a single-performance obligation for the delivery of gold bullion to the Bank. The Refinery never accepts risk or rewards in the process of refining and never takes title to the good being delivered. Despite having physical possession of the gold during refining activities, the Refinery never takes control over the goods within the meaning of IFRS 15. The Refinery is providing a service on behalf of MineCo to deliver a good to MineCo's ultimate customer, the Bank, who is paying for the goods to be delivered under the contract.

MineCo considers its identified customer and performance obligation in its determination of the point at which control transfers over the gold bullion. Considerations when determining the timing of transfer of control are addressed below (See section *Transfer of control over commodities: How does a mining entity evaluate transfer of control for a commodity and resulting revenue recognition?*).

Shipping and refining obligations: How should obligations associated with shipping a commodity to a customer or providing refining services be treated?

Shipping obligations

Generally speaking, commodities produced by the mining industry require shipment to a customer, and this may occur by air, road, rail or sea. The terms of shipping can vary from contract to contract and a review of contract terms is, therefore, necessary, given that they can have implications on both:

- Timing of the transfer of control (discussed further below, see Transfer of control over commodities: How does a mining entity evaluate transfer of control for a commodity and the resulting revenue recognition?); and
- Identification of performance obligations.

In circumstances where control over an underlying commodity has transferred to the customer, but physical shipment has yet to be completed and the mining entity is required to provide shipping and handling services, the mining entity applying IFRS 15 must determine whether the shipping and handling activities undertaken after transfer of control of the underlying goods are distinct from the shipped goods. If so, the shipping and handling services constitute a separate performance obligation and some of the transaction price must be allocated to the shipping and handling services and recognized as revenue when the shipping performance obligation is satisfied.

In order for the promise to provide shipping and handling services to be viewed as distinct from the promise to transfer control over the commodity:

a. the customer must be able to benefit from the shipping and handling services; and

b. the promise to provide shipping and handling services must be separately identifiable from the promise to deliver the underlying commodity.

Regarding (a), a mining entity should assess whether its customer may be able to obtain its own shipping services such that it can benefit from the commodity irrespective of the services it is offering. In many cases, a customer can obtain readily available shipping services.

Regarding (b), IFRS 15 contains factors for determining whether the shipping and handling services are not separately identifiable from the promise to transfer control over the commodity. Namely whether the shipping and handling services:

- provide a significant service of integrating goods or services provided under the contract, or
- significantly modify or customize the commodity, or
- of the commodity are highly interdependent or interrelated.

Typically, in the mining industry, the service of shipping and handling would not provide a significant service of integration and thus it is not a combined output. The shipping and handling services themselves would normally not significantly modify or customize the commodity being provided to the customer. Finally, the shipping and handling services would not be expected to be highly interdependent or interrelated to the commodity being sold.

If a contract's terms support the above analysis, they would indicate that the shipping and handling services are a separate performance obligation thereby requiring the allocation of some of the transaction price.

Example

Assumptions

- An entity (IronCo) mining iron ore at a remote location produces and sells an average of 200,000 tonnes of iron ore per quarter and makes a single, quarterly bulk shipment and sale to its customer who pays $75 per tonne.
- According to the terms of the contract with the customer, IronCo must also arrange for the shipment of the commodity to the customer's local port. IronCo has concluded that control over the underlying iron ore transfers at the point it is loaded onto a ship at its local port.
- IronCo has identified itself as the principal for the shipping activities.

If, based on the details of the contract, the shipping is considered a separate performance obligation and the amounts are considered material (which could be the case for high-volume, low-value bulk shipments), the allocated revenue and the related costs are recognized when or as the shipping service is provided. The transaction price is allocated to the separate performance obligations based upon their relative stand-alone selling prices as required by IFRS 15.

Assume IronCo determined at contract inception that the stand-alone selling price for iron ore is $72 per tonne and the stand-alone selling price for bulk shipments of this nature is $8 per tonne (a total of $80).

Assume IronCo had no observable evidence that the difference between the transaction price and the sum of the stand-alone selling prices related to only one of these performance obligations. As a consequence, $7.50 of each tonne delivered ($7.50 = $75 transaction price × ($8 ÷ ($72 + $8)), representing an allocation of the transaction price based on the relative stand-alone selling prices, would need to be deferred and only recognized when or as the shipping services were provided.

Refining services

A mining entity may enter into a contract with a customer (typically a bank) to sell a mineral in an unrefined form and separately commit to arrange for the performance of refining services in respect of the mineral provided to the bank. Alternatively, the contract with a customer may instead be for delivery of the refined product. As transfer of control over the unrefined mineral might occur before the completion of refining services, the conclusion as to whether these two represent a combined promise may have implications for the timing and nature of revenue recognition. Consistent with the requirements outlined above, careful consideration of contract terms is important in first identifying the performance obligations which are distinct within the context of the contract.

It may be that the customer can benefit from the unrefined mineral because it can either sell it as is or arrange for its own refining services to transform it into a refined product (i.e., the refining service is distinct).

In assessing whether performing the refining service is distinct from providing the unrefined mineral in the context of the contract, a mining entity will need to assess whether these two acts constitute a combined promise (i.e., combined output) to provide refined mineral to the customer. Depending on how a contract is written, it is possible that these obligations are distinct in that the customer has expressed an interest in purchasing the underlying unrefined mineral and is separately contracting to obtain refining services. A careful review of all the terms of the contract is, however, necessary.

Transfer of control over commodities: How does a mining entity evaluate transfer of control for a commodity and the resulting revenue recognition?

An entity first determines whether its performance obligation is satisfied over time. If it is not, then the performance obligation is satisfied at a point in time. Satisfaction of performance obligations related to the provision of commodities generally occurs at a "point in time". For performance obligations satisfied at a point in time, an entity is required to consider indicators of the transfer of control which include, but are not limited to, the following:

- The entity has a present right to payment for the asset.
- The customer has legal title to the asset.
- The entity has transferred physical possession of the asset.
- The customer has the significant risks and rewards of ownership of the asset.
- The customer has accepted the asset.

Any one of these indicators alone is not determinative and not all indicators are required to be present for control to have passed. Rather, an entity should consider these indicators in combination. Notably, control over the commodity for accounting purposes may transfer at a point before or after the physical delivery of the commodity to the customer since physical possession is only one of the above indicators.

Example

Assumptions

- MineCo produces and ships unrefined gold bars to the Refinery on the Delivery Date.[3] The gold is then refined into gold bullion and, absent other instructions, the Refinery credits the refined ounces to MineCo's metal account.
- Sales with a Bank are executed via individual trade confirmations that identify the seller and purchaser, the quantity to be sold, the contract price per ounce, the total price, and the delivery location (in reference to the Bank's metal account). The confirmation also outlines the:
  - Trade Date: the date the parties agreed to the terms of the sale
  - Settlement Date: the date the metal will be transferred to the Bank's gold bullion account
  - Payment Date: the date the Bank pays MineCo.

MineCo considers the indicators under IFRS 15 in the following two illustrative scenarios to determine when control over the commodity has transferred and revenue is recognized:

3 The Delivery Date refers to the date the unrefined gold bars are delivered to the refinery.

Scenario 1 – Gold in an unrefined gold bar sale:
On the Trade Date, MineCo enters into a contract to sell to the Bank a specified quantity of gold ounces contained in an unrefined gold bar it sends to the Refinery (generally less than the estimated total gold ounces contained within the unrefined gold bar). Following the Delivery Date, the Refinery confirms receipt (Refinery Confirmation) of irrevocable instructions from MineCo and the Bank to deliver the specified quantity of gold ounces directly to the Bank's metal account upon completion of refining, provided the Bank has paid MineCo for the specified ounces. The Bank commits to pay for the ounces upon receipt of the Refinery Confirmation.

Assume MineCo has concluded that the contract is two performance obligations for which it acts as principal and for which the Bank represents its customer:

1. for the delivery of gold embedded within an unrefined gold bar
2. to perform refining services.[4]

MineCo has determined that delivery of the gold is satisfied at a point in time.

Through review of the contract's terms, MineCo determined at the Delivery Date that the Bank would accept the purchased gold ounces since there are specifications that the gold ounces must meet (e.g., purity), and the Refiner's irrevocable refining instructions align with these specifications. At the Delivery Date, MineCo also determined it has an enforceable right to payment because irrevocable and unconditional instructions to deliver the gold ounces were issued to the Refiner and that it has transferred the risk and rewards of ownership to the Bank. Upon the Payment Date, the Bank irrevocably accepts title to the purchased ounces (i.e., transfer of title occurs).

For the purposes of this example, MineCo's analysis of the indicators determined that control transferred on the Delivery Date. This evaluation requires careful consideration of specific facts and circumstances unique to each contract.

At the Delivery Date, the Bank had the ability to direct the use of, and obtain substantially all of the benefits from, the gold contained in the unrefined gold bar. Therefore, MineCo concluded that revenue relating to the sale of the unrefined gold bar would be recognized at the Delivery Date.

4 The analysis that follows focuses on the evaluation of transfer of control over the gold embedded within the unrefined gold bar; a separate analysis would need to be undertaken for the refining services as this would be considered a separate performance obligation in this scenario.

Scenario 2 - Refined gold bullion sale:

MineCo produces and ships unrefined gold bars to the Refinery, but at the Delivery Date, MineCo has not entered into any contract to sell the commodity and has not provided any irrevocable instructions to the Refinery to transfer the gold contained within the unrefined gold bars to any specific customer. The gold is then refined into gold bullion and the Refinery credits the refined ounces to MineCo's metal account.

MineCo subsequently enters into a refined gold bullion sale. On the Trade Date, MineCo instructs the Refinery to transfer the agreed-upon quantity of gold from MineCo's metal account to the Bank's metal account on a specified future date (Settlement Date), at which point the Bank is irrevocably committed to pay MineCo on the Payment Date. Assume MineCo determined that the contract is a single-performance obligation for delivery of gold bullion at a point in time, that it acts as principal, and that the Bank is the customer.

At the Settlement Date, MineCo determined it has a right to payment and that transfer of legal title and physical possession of the goods[5] has occurred. MineCo also determined that, prior to the Settlement Date, it retained the risks and rewards of ownership and, therefore, control over the gold, because, if the ounces were lost between the Trade Date and the Settlement Date, the loss would be borne by MineCo (absent any insurance or other arrangements between MineCo and the Refinery). The Bank has accepted the refined metal at this point because the characteristics of the refined metal transacted are specified in the trade confirmation (i.e., commodity type and location for delivery). Based on a fulsome review of the contract terms in this simplified example, MineCo concluded that indicators of control are present at the Settlement Date and, accordingly, revenue should be recognized.

Provisional pricing: How should a mining entity address the unique pricing issues associated with provisionally priced contracts?

Sales contracts for certain commodities include provisional pricing at the time of shipment of ore or a mineral concentrate with final pricing based on a future price. The final sales price may be based on the average market price for a particular future period (quotational period) or the price on a fixed date after delivery. This type of arrangement is common when a mining entity produces a mineral concentrate that is sold to a smelter or refinery which, in turn, sells the metal upon eventual outturn. Between the initial shipment and final settlement, variability in the payment on settlement could occur due to (a) fluctuation in prices, or (b) fluctuation in metal content after the metal is further assayed and the metal content is agreed upon by the parties.

5 While literal physical possession of gold bullion rarely passes in practice (e.g., in the case where the gold bullion remains secured at the Refinery's premises), allocation of refined gold to a customer's gold bullion account can be regarded as "delivery." For further information on the meaning of "delivery," see the **IFRS Interpretation Committee's August 2005 newsletter**.

Variability due to fluctuation in commodity prices

Price adjustment features in provisionally priced commodity contracts often meet the definition of an embedded derivative. Under IFRS 9, *Financial Instruments*, embedded derivatives are not separated from financial assets (i.e., the underlying commodity-sale trade receivable) and the requirements of IFRS 9 are applied to the contract as a whole. At the date of sale, the resulting trade receivable is recognized and is subject to future changes in the commodity price; therefore, under IFRS 9, it would fail the contractual cash flow test and hence would typically have to be subsequently measured at fair value through profit or loss. A question arises as to how to characterize the gains and losses associated with these price adjustments.

IFRS 15 states that, if a contract is partially within its scope and partially within the scope of another standard, entities will first apply the separation and measurement requirements of the other standard(s).

In such circumstances, revenue in respect of the host contract (i.e., the commodity sales contract) should be recognized when control passes to the customer and will be measured at the amount to which the mining entity expects to be entitled (i.e., the estimate of the price expected to be received at the end of the quotational period). Provided control passes before the end of the quotational period, any movements in the fair value of the trade receivable throughout the quotational period will be recognized in profit or loss. The movements associated with the financial instrument are distinct from revenue from contracts with customers.

Variability due to fluctuation in metals quantity:

Often (such as in the sale of a base metal concentrate) following delivery to the customer, a settlement period can exist during which the customer conducts further assays to confirm the quantity of material shipped, which in turn affect the final transaction amount. For contracts where the consideration may fluctuate depending on the actual quantity of commodity contained within the product shipped (i.e. changes in the assay between initial estimated quantity and final settlement quantity), an entity determines whether the adjustment to quantity represents (1) confirmation of the actual quantity delivered, (2) more than just confirmation of quantity, but not variable consideration within the scope of IFRS 15, or (3) variable consideration within the scope of IFRS 15.[6]

If the entity determines the adjustment to represent variable consideration, it only includes amounts of variable consideration in the transaction price to the extent it is "highly probable" a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved. If initial assay results at time of shipment had an expected high level of inaccuracy, the mining entity should constrain the amount of revenue that it recognizes on initial shipment of the commodity based on the "highly probable" threshold.

6 The consequences of each interpretation are discussed further within the IFRS Discussion Group's meeting January 10, 2018, with respect to the topic "*IFRS 9 and IFRS 15: Scope Interactions*" published on the Financial Reporting and Assurances Standards Canada website: www.frascanada.ca/international-financial-reporting-standards.

Regardless of interpretation, in many cases, the seller has a high level of confidence in the preliminary estimate of total metal content of the shipment based on the historical precision level of their own assays, such that treatment of this variability as variable consideration may not have a material impact. In circumstances where an entity has significant uncertainty about the quantity sold and the entity determines the variability is variable consideration, this could result in a mining entity having to constrain the transaction price and, consequently, any revenue recognized until that uncertainty is resolved. Once the uncertainty is resolved, any final adjustments would be recognized and disclosed as adjustments to IFRS 15 revenue. (i.e., revenue from contracts with customers) and may trigger additional disclosures under IFRS 15 if such adjustments are recognized in subsequent reporting periods.

The Mining Industry Task Force on IFRS Standards

Members

Ronald P. Gagel, CPA, CA (Chair)
Prospectors & Developers Association of Canada
Toronto, Ontario

Bob Bosshard, CPA, CA
Prospectors & Developers Association of Canada
Toronto, Ontario

Pierre Cusson, CPA, CA
Raymond Chabot Grant Thornton LLP
Montreal, Quebec

Murtaza Dean, CPA, CA
MNP LLP
Toronto, Ontario

Anne-Marie Henson, CPA, CA
BDO Canada LLP
Montreal, Quebec

Thomas Karanikolas, CPA, CA
Hudbay Minerals
Toronto, Ontario

Blake Langill, CPA, CA
Ernst & Young LLP
Toronto, Ontario

Sunny Lowe, CPA, CA
INV Metals
Toronto, Ontario

James Lusby, CPA, CA
PricewaterhouseCoopers LLP
Toronto, Ontario

Keith McKay, CPA, CA
Dalradian Resources Inc.
Toronto, Ontario

Ken McKay, CPA, CA
KPMG LLP
Toronto, Ontario

Julie Robertson, CPA, CA
Barrick Gold Corporation
Toronto, Ontario

Cameron Walls, CPA, CA
Deloitte LLP
Vancouver, British Columbia

Blair Zaritsky, CPA, CA
Osisko Mining Inc.
Toronto, Ontario

Staff

Michael Massoud, CPA, CA CPA (IL)
CPA Canada
Toronto, Ontario

For more information on IFRS visit: www.cpacanada.ca/viewpointsmining.

Comments on this *Viewpoint* or suggestions for future *Viewpoints* should be emailed to: ifrsviewpoints@cpacanada.ca.