PKF Littlejohn LLP

PKF
Accountants & business advisers

CAPITALQUARTER

The newsletter for listed businesses and their advisers

WINTER 2019/20

MINING SPECIAL

Is fraud costing your mine?

Beware the fraudsters going unchecked.

Win back trust

Make sure your mine moves with the times.

The value of valuations

Why they are critical to the mining cycle.

Plus:

Our guide to reverse acquisitions for listed companies.

How to prepare for off-payroll tax changes.

IFRS 16 leases.

CAPITAL MARKETS

Welcome

Welcome to the Winter 2019/20 edition of Capital Quarter - our newsletter for listed businesses and their advisors. This issue focuses on the Mining sector, covering a number of emerging issues in this space.

Fraud is never a nice topic for senior management or boards to think about but is a key risk that needs to be mitigated, and the mining sector is no exception. Martin Moore from PKF Littlejohn's Forensic & Fraud team offers specialist advice on what mine owners need to consider when tackling fraud. He speaks from experience to advise you on what to look out for.

Also in this issue of Capital Quarter:

- Reverse acquisitions; John Black advises on the key considerations for companies looking to obtain a listing via this method
- Adam Humphreys outlines what mining companies need to do modernise in a changing sector and…
- Beware of off-payroll tax regulation changes; Chris Riley urges business to be cautious of changing regulations surrounding employment status workers hired via an intermediary.

We hope you find this edition useful, and we are always keen to hear your comments and suggestions for future articles.

Kind regards,

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Looking Ahead

Reporting dates for companies

JANUARY 2020

SUNDAY	MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY	SATURDAY
			1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28	29	30	31	

1st Public Holiday (markets closed)

31st Due date for Premium & Standard listed entities (September year ends)

FEBRUARY 2020

SUNDAY	MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY	SATURDAY
						1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23 / 30	24	25	26	27	28	29

29th NEX deadline (September year ends)

29th Due date for Premium & Standard listed entities (October year ends)

Valuations: how you can benefit

Valuations are a critical part of the mining lifecycle. Cheryl Court highlights the key moments when you can use valuation techniques to improve both your understanding of risk areas and your assessment of a project.

Valuation insights provide vital input during initial exploration, the production phase, and also during subsequent closure of a mine. You can use these insights to inform your decision-making, whether on the viability of a mining project or subsequent fundraising, and also to meet financial reporting requirements.

Viability support

At the exploration phase, you would already have commissioned a Competent Persons Report (CPR) to confirm viability of the mine. As valuers, we work closely with those who prepare the CPR to challenge assumptions about extraction rates, volumes available, mineral grades and the capabilities of chosen machinery. We analyse outcomes and run sensitivities over the results. This provides a fuller understanding of the impact from changes in assumptions which will, in turn, highlight the key drivers of value. Finally, these conclusions will help you to decide whether or not the mine should be developed.

Fairness from investors

From a fundraising perspective, we use our experience and available market data to challenge feasibility reports in order to determine whether the proposed investment is fair and reasonable for the investees. By reviewing and flexing base case scenarios we can establish the range of outputs required to meet with expected minimum returns.

Best E&E recognition

Under IFRS 6, you can capitalise Exploration and Evaluation (E&E) costs. For most mining companies this will be a significant asset in your financial statements. Once you have identified your expenditure, you will record these assets at cost on initial recognition.

For subsequent measurements, you have a choice between the cost model (depreciation/amortisation of each asset when it's ready for use) and the revaluation model (measured at fair value where there is an active market for comparable intangible assets). A valuer can help you to identify the active market and advise on the recognition approach.

E&E valuation challenges

E&E assets must be assessed for impairment when facts and circumstances suggest their carrying amount exceeds their recoverable amount. At the development and production stage, more definitive information is available. You can engage valuers to assess the current worth of the mine's assets, based on management-prepared assumptions which are sensitised against known market data.

Using the reports produced, you may need to make decisions on any impairment of value as a result of, say, delays in development, lower than expected extraction rates, or lower grades of available minerals.

Fair price machinery

Mining requires specialist plant and machinery, which companies often purchase second hand. If you plan to buy from a closed mine, you can use valuation support to make sure you pay a fair price, with a comparison to recent market data of a similar asset or replacement cost, depreciated for age and condition. The valuation will often involve a physical inspection and be carried out ex-situ, considering the costs to relocate the plant.

Appointing a valuer at these key stages will help to challenge mining expert reports. It will make it easier to consider the impact of value detractors - allowing detailed risk analysis throughout the project.

For more information contact Cheryl Court.

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What is fraud costing your mine?

Economic challenges abound in the mining sector. But these are being made much worse by the actions of fraudsters that are going unchecked. Martin Moore reports.

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The international mining sector faces many financial pressures that affect its profitability. Many of these relate directly to mining expenditure - like rising energy prices, increased construction costs, geological difficulties or increasing pay demands. Other pressures come from indirect mining costs associated with haulage, rail freight charges, roadway upkeep, security of plant and machinery, water treatment and camp costs. It appears that whatever the cost in mining, it's going to be big.

A mine general manager will invite departmental heads to talk about the costs of drilling, engineering, diesel usage, truck maintenance or average tonnes produced per day, week or month. And he will consider how output can be increased. There will be discussions about crushing, smelting and refining - all designed to increase the all-important financial margin.

The hidden enemy

Meanwhile, in the background, being given very little attention, and rarely getting any mention at all at senior management meetings, are other mining entrepreneurs who also have an interest in profitability. They too have discussions on how they can increase their margins. The only difference is that they have their own interests at heart, not necessarily those of the company.

This group will collude with other 'interested parties', both internally and externally, to see how they can 'make a bit extra on the side'. With no apparent deterrent, what starts off as a few dollars of extra pocket money, gradually escalates until the profitability of the company is being compromised.

You may not be able to steal a tyre from a 400-tonne capacity dump truck in the boot of your car, but if you can make it disappear on paper you have earned yourself lots of money. If the back office is not managed sufficiently well, any increase in production will be offset by the increased profitability of the fraudsters.

Those you least suspect

Experience has shown that members of the 'in-camp fraud team' will include some of the very people you would hope would uncover and report fraudulent activity. These are managers in prominent positions, quite often ex-pats who can abuse their position over more junior members of the workforce.

There is also evidence that local workers in less influential positions in the company can exert pressure on more senior employees to do wrongful acts by using their status outside the organisation. This may be because they have influence within a tribe or external group.

Contractor malpractice

You can guarantee that there will be pressure placed upon procurement staff to award contracts to friends and family members. Collusion between outside contractors to rig bids for work opportunities is also highly likely. Working together, these groups can artificially inflate the price the mining organisation has to pay for external contractors. The bid rigging will be aligned so that other members of the syndicate get a slice of the work. Sometimes they are appointed as a sub-contractor, or contracts are deliberately alternated between one contractor and another on a rotation basis.

Fraudulent examples

On one mine in Central Africa, PKF Littlejohn fraud investigators identified overruns on a number of externally managed vehicle maintenance contracts. Staff were being managed and paid from a manual booking-on sheet. We mapped this data against workers entering the site at its security-controlled entry/exit gates. Our analysis showed that many of the workers who had allegedly signed in via the booking-on sheet, had not in fact been on the mine site. The contractor had even managed to negotiate an additional fee to complete the contract, due to the overrun. The fraud was stopped, the policy was changed, and the overcharge reclaimed.

In West Africa the country manager at an exploration mining operation had set up a number of his own supply companies using shadow directors to front them. He was awarding contracts to these companies and supplying inferior products. As a result, he wasn't getting the best value for the exploration company but was benefitting financially himself.

Invoice fudging

In a third example, a multinational parts supplier was invoicing for parts it was allegedly supplying in relation to a vehicle fleet. Each invoice contained 18 items per sheet and had as many as 130 pages. It was impossible for anyone in the accounts department to check the validity of the invoices, so each one was being paid on trust.

Using specialist analytical software, the PKF Littlejohn fraud team was able to extract the data from the invoices, put it into Excel and sort it. What a different story the sorted data told. We found multiple entries of high and low value parts in the same invoice, which could never have been found without the data analysis. The mine was able to substantiate a case and reclaimed the over-charged items. They made a cost saving many times the fee for our PKF investigators.

Act now

You may be aware that these kind of situations exist within your operations. But perhaps you feel powerless to stop them, or don't know to what extent they are happening. If that's the case or if you would like more advice on this subject, please get in touch with our fraud team.

Beware off-payroll tax changes

Mining businesses will be affected by new rules for employment status workers hired via an intermediary. Chris Riley explains how to prepare for April 2020.

Consultants who provide advice to a business are a feature of all sectors. But for many years governments and HMRC have been concerned that the use of consultants, often off-payroll, is disguising for tax purposes what is truly an employment relationship.

Mining groups based in the UK will often make use of genuine third party consultants, for example geologists or other advisors, who provide their services through an intermediary. If these develop into more personal and permanent relationships they may come under the definition of Off Payroll working. Previously, payroll tax issues were captured on the intermediary business under the IR35 rules.

IR35 out of favour

The catch is that the Government doesn't believe IR35 works. It's already tackled the issue with success in the public sector. From April 2017, it moved the payrolling responsibilities for all employment relationships, whether an intermediary is in place or not, to the host employer.

So it's no surprise that the off-payroll working rules will now apply in all sectors from April 2020. Where a business falls within the regime from that date, all its relationships that have hallmarks indicating employment will need to be accounted for under PAYE.

Size matters

It's important to note that in the private sector not all companies will be caught by the legislation. Small businesses are exempt, and will not need to apply the new off-payroll working rules. A business is small if it meets two of the following three criteria – considered on a global consolidated basis.

- Annual turnover less than £10.2million
- Gross assets of less than £5.1million
- Less than 50 employees

A year's grace applies for businesses that grow and pass through these thresholds. In other words, the rules come into effect in the second year that a company is considered large.

I'm in the rules – how should I start?

If you are an affected organisation engaging an individual via a PSC, you must decide the worker's status and communicate it to both the worker and the person contracted with for the engagement, whether an agency or a PSC. HMRC's check employment status for tax (CEST) online tool is expected to be the primary method used to determine a worker's status.

This decision on status must be made with reasonable care and any disagreements about it resolved within 45 days of notification from the worker.

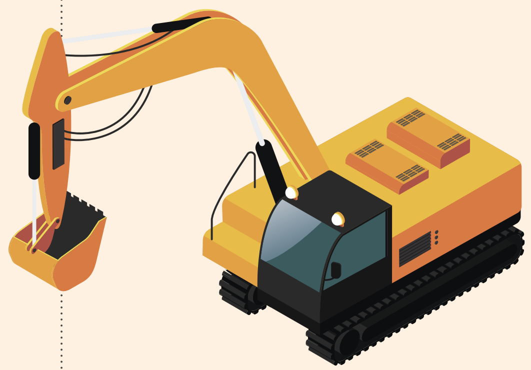
What if my consultant is caught?

Where the status determination is 'employee', an affected business engaging a consultant or any other worker via a PSC will be responsible for accounting to HMRC for PAYE and NIC due on all engagements, And the same applies where the business has failed to determine the status or not dealt with a status disagreement within the 45-day limit.

It's worth remembering that if you engage a consultant directly, without a PSC in place, these rules have always applied, regardless of the size of your business.

What else should I do now?

If you're a private sector entity and don't believe you'll qualify as 'small' on 6 April 2020, you need to review all current engagements where you have contracted with a PSC. Although the rules will not take effect until next April, we recommend you confirm these relationships and their tax status as soon as possible, so that all parties can plan for the changes.



From 6 April 2020, you'll need to hold supporting documents that confirm the status (employee or self-employed) of all engagements via PSCs. You must also have communicated that status to the worker and other required parties in the labour supply chain. Where the status is 'employment', you must account for PAYE and NIC on the payments made to the PSC after 6 April 2020.

For more information about any issues raised in this article, please contact

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Modernise to thrive

Consumer attitudes to mining have changed. In difficult times, what do companies need to do to win back trust and remain successful? Adam Humphreys considers the options.

The mining and metals sector is recovering from one of its most difficult periods in recent years. It has come under pressure from commodity price decreases and geopolitical changes.

In the UK, 'Mining and Industrial Metals' accounted for just 1% of funds raised through further issues on the London markets from January to July 2019. This is likely to reflect a change in perception of the mining industry, partly because of consumer appetite for creating low carbon economies.

Despite this, in 2018 global mining companies had a combined revenue of over US$683billion and the industry showed global year on year revenue growth.

It's clear that there will continue to be huge demand worldwide for mining and metals for many years to come. But the successful mining companies of the future will need to modernise to overcome the changing geopolitical landscape and a shift in how the market sees the industry.

So what are the factors these companies will need to consider?

Demand for 'low carbon'

Historically, the strategic goals of a mining company were likely to focus on maximising production for the lowest cost. The ever-growing pressure to reduce carbon emissions means that miners will need to increase emphasis on corporate social responsibility (CSR) in their strategic plans. Spending on CSR programmes will become less an act of compliance than a genuine market differentiator and value creator.

The mining sector must demonstrate how it is reducing its emissions and innovating to find cleaner methods of extracting resources. Some miners are aiming to differentiate from competitors by fuelling their operations from renewable sources.

Global low-carbon strategies may also provide opportunities for the sector. Why? Because in order to de-carbonise energy systems, countries must move to low-emission energy sources, and these are often more mineral intensive than fossil fuel alternatives.

The importance of technology

Compared to many other industries, mining is behind the curve in its technological maturity. Digitisation of processes will produce better non-financial data. And this, in turn, can inform operations, improve efficiencies and reduce waste. Successful modern mining companies are investing in and embracing these technologies earlier than their competitors.

Better stakeholder engagement

Increased activism and engagement from local communities can lead to difficulties in obtaining social licenses to operate. That's why corporate strategy must now place far more importance on new models and initiatives to win local community buy-in.

Transparency in operations and regular communication with all stakeholder groups, through strong corporate governance, is vital. It will help mining companies to keep stakeholders informed of key initiatives and of the benefits the industry can bring to their community.

New funding solutions

Mining operations are, by their nature, capital intensive projects. After the decrease in commodity prices in the last decades, many mining operations found themselves burdened by suffocating debt covenants and high debt ratios.

Recently there has been more conservatism in funding instruments, a situation that's bound to continue throughout the current period of economic uncertainty. So it will be all the more important to spread the risk of the capital projects, and alternative funding solutions that support this will likely be favoured.

So while the mining sector is well poised to capitalise on the current economic climate, it will also require modernisation of the industry and increased stakeholder engagement.

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Reverse acquisitions: get a fast-track listing

The accounting treatment of a reverse acquisition by a listed company can be complicated. John Black outlines the key considerations for operating companies obtaining a listing this way.

A reverse acquisition is said to have occurred when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes. The entity whose equity interests are acquired (the legal acquiree) must also be the acquirer for accounting purposes.

Reverse acquisitions can occur when a private operating company is seeking a listing to a stock exchange but does not want to register its equity shares from scratch. Instead, it is looking for a fast-track listing by arranging for a listed shell company to acquire them in a share for share transaction.

Understanding 'business combination'

How do you know if a 'business combination' has taken place? First, it's important to assess who the accounting acquirer is; and secondly, whether the assets being acquired and liabilities assumed constitute a business.

You should use the guidance in IFRS 10 to identify the accounting acquirer - this means the entity that obtains control of another entity (the acquiree). More often than not in these transactions the shareholders in the operating company will obtain a controlling interest, and this usually indicates that the operating company is the accounting acquirer.

Defining a 'business'

Does the shell company (accounting acquiree) constitute a business as defined in IFRS 3? Typically a cash shell fails to meet this definition of a business because its activities are usually limited to managing the cash and complying with its regulatory obligations.

IFRS 3's definition of a business: "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants."

This definition was amended in October 2018 for accounting periods beginning on or after 1 January 2020. The changes are not expected to alter the position for acquisitions by listed shell companies but are likely to affect more complex transactions.

So an operating company that obtains control over a listed company which does not constitute a business is not a 'business combination' and therefore is outside the scope of IFRS 3.

What to put in financial statements

So what is the accounting treatment when the transaction is not a 'business combination'? Despite being outside the scope of IFRS 3, the cash shell has become a legal parent and therefore must prepare consolidated financial statements. It's widely accepted that these should follow the reverse acquisition methodology from IFRS 3, but without recognising goodwill.

Consolidated financial statements prepared following a reverse acquisition are issued under the name of the legal parent (accounting acquiree). But they are described in the notes as a continuation of the financial statements of the legal subsidiary (accounting acquirer), with one difference. This is to adjust retroactively the accounting acquirer's legal capital to reflect that of the accounting acquiree. Comparative information presented in these consolidated financial statements is also retroactively adjusted to reflect the legal capital of the legal parent.

Rather than recognising goodwill, any excess of the deemed acquisition cost over the fair value of the assets and liabilities of the listed shell company is considered to represent the cost of the operating company obtaining a listing. This is accounted for as a share-based payment within the scope of IFRS 2.

The appeal to mining companies

Fast-track listings are appealing to mining companies, especially those in the exploration phase, because they are often in need of cash quickly in order to progress their projects. By obtaining a listing, a company can greatly improve its accessibility to investors and their cash.

Getting fast-track help

What should you do if you are an operating company seeking a fast-track listing? We recommend you appoint professional advisors from the beginning of your journey. PKF Littlejohn's experienced and dedicated Capital Markets team can advise you throughout the process and guide you through the accounting complexities of the transaction. For more information please contact.

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IFRS 16 Leases: what you need to know

As we come to the end of the first accounting period for the new standard, Imogen Massey provides a quick guide for mining companies.

The new lease accounting standard, IFRS 16, came into effect on 1 January 2019 and many companies will already have adopted it in their interim financial statements. The standard supersedes IAS 17 and introduces a single lease accounting model.

The standard applies to all leases, including those within a sublease arrangement, except for the following:

- Leases to explore for or use minerals, oil, natural gas
- Leases of biological assets
- Service concession arrangements
- Licences of intellectual property
- Rights held by a lessee under licensing agreements within the scope of IAS 38 Intangible Assets.

What is the focus of IFRS 16?

The new approach aims to achieve greater comparability between companies for both users and preparers of financial statements. It does that by obtaining a more faithful representation of the assets and liabilities that are, in substance, held.

It impacts lessees by requiring them to recognise assets and liabilities for the rights and obligations created by leases. The objective is greater transparency through enhanced disclosure.

Lessor accounting remains substantially unchanged. But lessees must now recognise right of use assets (the right to use the underlying leased asset) and corresponding lease liabilities (the obligation to make lease payments) for all leases, with these limited exceptions:

- Lease term under 12 months ('short term leases')
- Underlying asset of low value ('low value leases').

Exactly what is meant by 'low value leases' is not clearly defined. So this can be decided lease-by-lease, taking into account the type of underlying asset, its inherent value, and its importance in the core operations of the business.

What are the chief impacts?

Key financial metrics

When they implement IFRS 16, companies will see an impact on financial position, financial performance and cash flows. They must recognise depreciation of the right of use asset and finance costs on the lease liability. The cash repayments of the liability will be classified into a principal and an interest portion and presented in this way in the statement of cash flows.

These changes will affect a company's key financial metrics, which may vary depending on the nature of the business. Companies will see changes in gross/net assets, liabilities (including classification as current or non-current), depreciation and interest expense, profit before/after tax and EBIT/EBITDA.

As a result, it will be important to consider the impact on bank covenants, key performance indicators including those affecting bonus structures, ability to obtain financing, or fluctuations in share price. Also vital will be an open dialogue to keep key stakeholders informed.

Disclosures

The changes in disclosure under IFRS 16 aim to provide sufficient information for users of the financial statements to assess the impact of leases on the mining company's financial position, performance and cash flows. Disclosure requirements should be presented in tabular format.

Mining industry specific considerations

Consider contracts that may be affected by IFRS 16, such as:

- Service contracts which include use of assets
- Shipping/transport contracts
- Mine camp arrangements
- Mining services/construction contracts
- Rental contracts
- Power supply contracts.

There are three key considerations to establish whether a contract contains a lease.

1 Is there an identified asset?

If all of the following apply, then there is an identified asset:

- An asset is specified in the contract
- The asset is physically distinct, or the customer has the right to receive substantially all of the capacity of the asset
- The supplier does NOT have substantive substitution rights.

EXAMPLE: Customer A has entered into a contract for the rights to store spare equipment parts in supplier B's warehouse. The contract terms stipulate a specific area of the warehouse, exclusively available to customer A, and supplier B has no substitution rights → there is an identified asset.

2 Does the customer obtain substantially all of the economic benefits?

This includes the primary output of the asset as well as any by-products and other commercial benefits arising, such as subleasing transactions.

EXAMPLE: Mining entity A enters into a contract with power supplier B to purchase all electricity produced by the plant over a 20-year period. A will therefore obtain all of the primary product (electricity) from use of the asset. However, B will obtain tax credits relating to ownership of the plant as well as renewable energy credits from use of the asset → it is not clear whether A obtains all of the economic benefits from use of the asset, so further analysis would be required.

3 Who has the right to direct the use of the asset? Who decides HOW and FOR WHAT PURPOSE the asset is used?

Customer: contract contains a lease

Predetermined: further analysis required

Supplier: contract does not contain a lease

EXAMPLE: Mining entity A enters into a contract with supplier B for the use of accommodation units at a mine camp over a five-year period, in which compensation is based on occupancy rates. The assets are identified and the purpose of the units is predetermined in the contract. However, A has control over when and how much the assets are used and where they are to be placed on the mine site → A makes the HOW and FOR WHAT PURPOSE decisions.

They include but are not limited to:

- Depreciation charge for right-of-use assets by class of underlying asset & interest expense on lease liabilities
- Expense relating to short-term leases & low value assets (see above)
- Expense relating to variable lease payments not included in the measurement of lease liabilities
- Total cash outflow for leases
- Carrying amount of right-of-use assets by class of underlying asset
- A maturity analysis of lease liabilities required by IFRS 7, shown separately from other financial liabilities.

Any qualitative information considered relevant to understanding the impact of leases should also be included.

For more information about how to implement IFRS 16, please contact

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