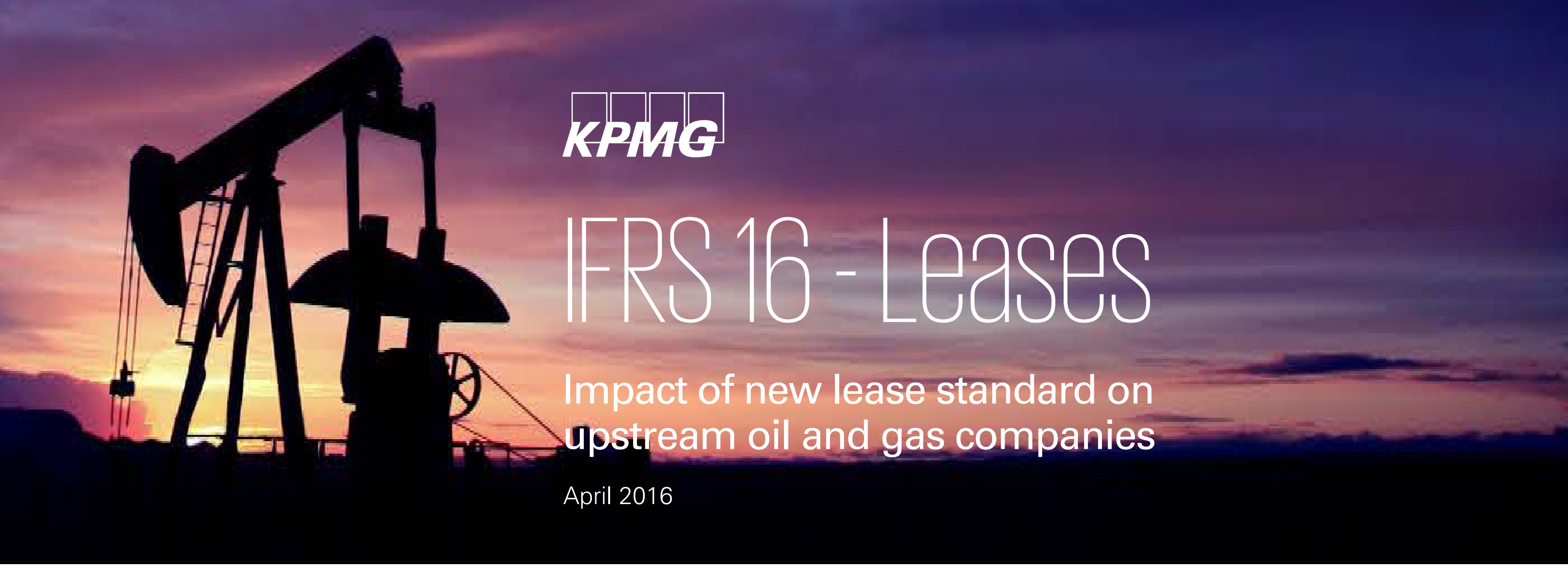

IFRS 16 - Leases

Impact of new lease standard on upstream oil and gas companies

April 2016

IFRS 16 Leases was issued in January 2016, replacing the existing IFRS lease accounting guidance, and introducing a new on-balance sheet model for lessee accounting which will impact upstream oil and gas companies.

The underlying objective of the new standard is to have lessees recognize assets and obligations arising from most leases on the balance sheet. Lessor accounting remains similar to current practice – i.e. lessors continue to classify leases as finance and operating leases.

Upstream oil and gas companies may currently apply lease accounting for transportation contracts, drilling rigs, compressors, tanks and other equipment, as well as rentals of vehicles, office space and office furniture, depending on the terms of the agreement and the nature of the assets.

Depending on the significance of these arrangements to your organization, the new standard will impact the financial statements and the key financial metrics used to report results to a corresponding degree.

While IFRS 16 doesn't take effect until January 2019, companies would benefit from some early consideration of the new standard – both to size up the magnitude of the effort that will be required to adopt it, as well as the magnitude of the impact on financial reporting in order to facilitate early communication to boards, shareholders and analysts.

How will the accounting change?

To the extent that operating leases are brought on-balance sheet, companies will recognize a lease liability representing the obligation to make lease payments over the term of the lease and a corresponding right-of-use asset that will be depreciated over the term of the lease.

As a result of measuring the liability at amortized cost using the effective interest rate, lessees will recognize a front-loaded pattern of expense, even when they make constant periodic lease payments. Importantly, operating lease expense will be replaced by a combination of depreciation expense arising from the recognition of a right-of-use asset and interest expense from the obligation to make lease payments under IFRS 16. This means that operating netbacks and EBITDA may increase under the new standard.

These changes will have a knock-on effect on the statement of cash flows. Principal repayments of the lease liability will be recognized as financing activities with interest payments as deductions from either operating or financing activities, whereas currently operating lease payments reduce cash flows from operating activities.

The net result of these changes is that leverage ratio calculations and disclosures of other commonly used non-GAAP measures for upstream oil and gas companies (e.g. funds from operations, operating netbacks) will likely change after adoption of IFRS 16.

The expected impact on financial ratios is as follows:

Balance sheet	Income statement	Cash flows
Total assets ↑ Total debt ↑	Operating costs ↓ Operating netback ↑ EBITDA ↑ Finance expense ↑ DD&A ↑ Net earnings ↓ (in early years) ↑ (in later years)	Cashflows from operating activities ↑ Funds from operations ↑

Does the contract contain a lease?

Given that contracts that are determined to be leases will now be on-balance sheet for lessees, one of the most important early considerations will be around the scope of the standard. Companies will need to understand whether contracts are, or contain, a lease.

Service contracts that do not meet the definition of a lease will continue to be accounted for as an executory contract. Similar to existing guidance, IFRS 16 specifically excludes leases to explore for or use oil, natural gas, and similar non-regenerative resources. IFRS 16 defines a lease as *a contract that conveys the right to control the use of an identified asset for a period of time in exchange for consideration.*

While on the surface it appears that IFRS 16 retains the current definition of a lease in IAS 17, there are important changes illustrated in the application guidance and new judgments will be required in certain key areas.

Identified assets

A contract contains a lease only if it relates to an identified asset. An identified asset is either explicitly or implicitly identified in a contract. Like existing guidance, a portion of the capacity of an asset can be an identified asset if it is physically distinct.

For example, the floor of a building is a physically distinct portion of a building. An asset that is not physically distinct would not constitute an identified asset unless it represents substantially all of the capacity of the entire asset.

While unchanged by IFRS 16 it is an important reminder that an undivided working interest in an identified asset (e.g. a 70% undivided working interest in a gas processing facility) is not considered physically distinct as it represents partial ownership in the identified asset. Agreements that convey the right to use an individual working interest in an asset are not within the scope of the lease standard.

Determining whether a specified capacity of a pipeline is physically distinct in transportation contracts will continue to be challenging for oil and gas companies under the new standard. If a customer uses or has rights to use substantially all of the capacity of the entire pipeline, the pipeline may constitute an identified asset.

However, for customers whose firm committed volumes represent only a portion of the capacity, it will be more difficult to conclude there is an identified asset. In addition, capacity of different legs of a pipeline may also vary, further complicating the assessment of whether the asset is physically distinct.

Substitution rights

Like existing guidance, under IFRS 16, even if an asset is specified in the contract, the customer does not have the right to use an identified asset if the supplier has a substantive right to substitute the asset for an alternative asset during the arrangement.

Often contracts for drilling rigs, compressors, and tanks allow the supplier to substitute assets, or to use equipment other than the equipment noted in the contract, to perform services. However, IFRS 16 expands on what constitutes a substantive right to substitute and clarifies that the lessor has to have both the practical ability to substitute the asset and must benefit economically from exercising its right to substitute the asset.

Whether the lessor has the substantive right to substitute the asset may depend upon where the asset is located and the cost to make a replacement asset available. The alternate asset to be substituted must be readily available within a reasonable period of time for the right to be substantive.

Clauses that provide the customer the ability to obtain replacement assets during repairs, or obtain technical upgrades do not preclude a customer from having the right to use an asset. Contracts that allow a supplier to use the equipment leased to one customer for another customer must also be considered.

Lease definition

Once it is confirmed that there is an identified asset in the contract, the analysis moves to whether the customer controls the use of the identified asset throughout the term of the contract.

Existing guidance focuses on whether a customer has a right to obtain substantially all of the output of an asset or whether they control the operations of the asset, whereas IFRS 16 requires both criteria for a contract to meet the definition of a lease. This is likely to mean that some agreements that are currently treated as leases will no longer be after 2019.

To establish the customer has control over the use of the asset, the customer must have the right to direct the use of the asset throughout the term of the contract, or direct others to operate it how and for what purpose they choose.

Determining whether the customer has the ability to direct the use of an asset is one of the significant new judgment areas in the new standard. Pipeline contracts are often designed such that the owner(s) will predetermine the purpose and specifications of the system, and the operating procedures are determined using industry standards.

Companies may need to consider whether the contract terms provide the customer with the right and ability to change the use of the pipeline or direct others to operate the system in another manner. Similarly, specifications around the operations of drilling rigs, gas processing facilities and other equipment will require the same assessment.

On transition to IFRS 16, companies can elect to grandfather existing decisions around whether an arrangement is a lease or an executory (e.g. service) arrangement.

Since all leases will now be on-balance sheet, companies will need to consider whether the fact that less arrangements will be considered leases under the new definition justifies the effort of relooking at all arrangements that may contain leases.

Practical expedients

Leases of low value items

In order to reduce compliance costs for preparers, IFRS 16 introduces two optional exemptions that are worthy of some initial consideration. The first exemption allows a lessee to scope-out of IFRS 16 leases for which the underlying asset is of low value when it is new (even if the effect is material in aggregate).

The election for leases of low value items can be made on a lease-by-lease basis, and is intended to capture leases that are high in volume but low in value – e.g. laptops, mobile phones, portable printers, office furniture etc. IFRS 16 does not define 'low value', but the basis of conclusions refers to assets with a value of USD 5000 or less when they are new.

Short-term leases

In addition, a lessee may elect to exclude short-term leases, with a lease term of 12 months or less, from the scope of IFRS 16. If a lessee elects the short-term lease recognition exemption and there are any changes to the lease term – e.g. the lessee exercises an option that it had previously determined it was not reasonably certain to exercise – or the lease is modified, then the lessee accounts for the lease as a new lease.

Next steps

Adoption of IFRS 16 may require a substantial effort to identify all lease agreements and extract all relevant lease data. Careful consideration at the front-end of your project may help to minimize the compliance cost associated with the adoption of this new standard.

More judgment will be required in determining whether certain arrangements are in the scope of IFRS 16, and processes will change for recording leases. Investors and Boards will want to understand the impact of the adoption of the standard on the business, especially to key ratios and reporting metrics.

We would be delighted to meet with you to share our insights and experience in applying this new standard.

Contact us

Sharlene Wilson
Partner, Accounting Advisory Services
T: 403 691 8024
E: sharlenewilson@kpmg.ca