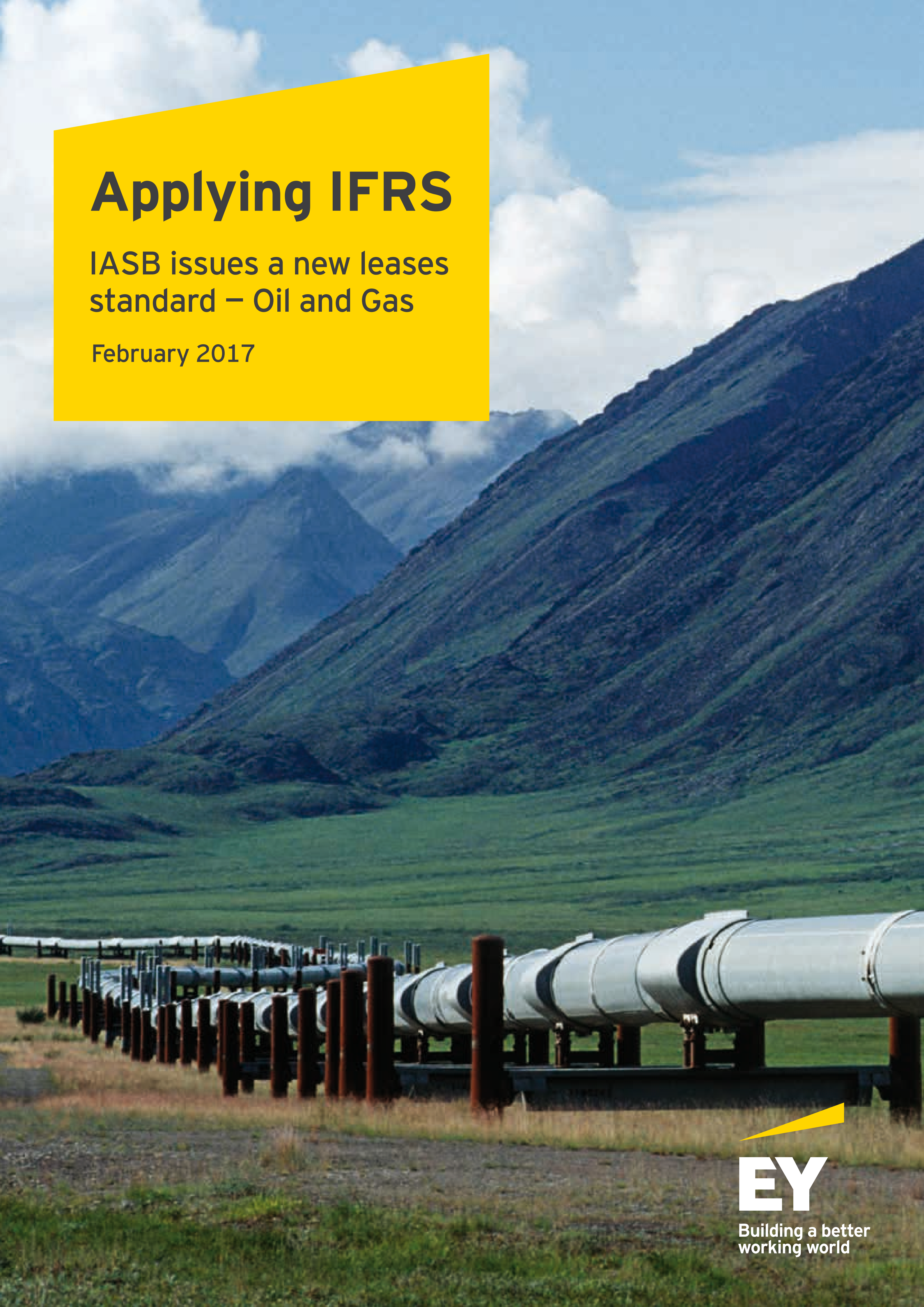
Applying IFRS

IASB issues a new leases standard – Oil and Gas

February 2017



Building a better working world

Contents

What you need to know

- The IASB has issued a new leases standard that requires lessees to recognise most leases on their balance sheets. For oil and gas lessees, this means recognising assets and liabilities for most leases of facilities and equipment that they may currently account for as operating leases.
- Lessees will apply a single accounting model for all leases (with certain exemptions).
- Lessor accounting is substantially unchanged and the IAS 17 *Leases* classification principle has been carried over to IFRS 16 *Leases*.
- Oil and gas entities may need to exercise judgement when applying the definition of a lease and allocating consideration between lease and non-lease components of a contract.
- The new standard is effective for annual periods beginning on or after 1 January 2019, with limited early application permitted.

Overview

IFRS 16 could have far reaching implications for oil and gas entities. The impacts go beyond accounting, to commercial decision making and strategic financial decisions.

Oil and gas entities will need to change certain lease accounting practices when implementing IFRS 16 *Leases,* the new leases standard issued by the International Accounting Standards Board (IASB). IFRS 16 significantly changes the accounting for leases by lessees, and could have far-reaching implications for oil and gas entities' finances and operations. For example, determining which agreements are in the scope of IFRS 16, applying the definition of a lease, and allocating contract consideration to the lease and non-lease components of contracts will require judgement.

IFRS 16 requires lessees to recognise most leases on their balance sheets as lease liabilities with corresponding right-of-use assets. Lessees will apply a single model for most leases. Generally, the profit or loss recognition pattern will change as interest and depreciation expenses are recognised separately in the statement of profit or loss (similar to today's finance lease accounting). However, lessees can make accounting policy elections to apply accounting similar to operating lease accounting under IAS 17 *Leases* to short-term leases and leases of low-value assets.

Lessor accounting is substantially unchanged from current accounting. As with IAS 17, IFRS 16 requires lessors to classify their leases into two types: finance leases and operating leases. Lease classification determines how and when a lessor recognises lease revenue and what assets a lessor records.

For oil and gas lessees, recognising lease-related assets and liabilities on their balance sheets could have significant financial reporting and business implications. IFRS 16 could influence commercial leasing decisions and financial strategies (e.g., a customer may consider shorter lease terms to minimise lease liabilities) and debt covenants and borrowing capacity may be affected.

Implementing the standard could also require an entity to develop new processes and controls to track and account for leases, including: (1) identifying a lease; (2) initially and subsequently measuring lease-related assets and liabilities; (3) identifying and allocating consideration to lease and non-lease components; and (4) collecting and aggregating the information necessary for disclosure.

In addition, because the current accounting for operating leases and service contracts is similar, entities may not have always focused on determining whether an arrangement is a lease or a service contract. Some entities may need to revisit assessments made under IAS 17 and IFRIC 4 *Determining whether an Arrangement contains a Lease* because, under IFRS 16, most leases are recognised on lessees' balance sheets, and the effects of treating an arrangement as a service instead of an arrangement containing a lease may be material.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019. Early application is permitted provided that the new revenue standard, IFRS 15 *Revenue from Contracts with Customers,* has been, or is, applied at the same date as IFRS 16. Lessees must apply IFRS 16 using either a full retrospective or a modified retrospective approach.

This publication summarises the new standard and describes some sector-specific issues that oil and gas entities may want to consider. Like all other entities, they will also need to apply the new standard to leases of office space, office equipment and all other assets within the scope of IFRS 16.

Our *Applying IFRS: A closer look at the new leases* standard (EYG No. 02173-163Gbl) issued in August 2016, provides an in-depth discussion of IFRS 16. We refer to that publication as our *General Applying IFRS*. Please refer to it for further information about the technical accounting topics and concepts discussed here. In addition, our *IFRS Practical Matters, Leases make their way onto the balance sheet: Navigating the journey for a smooth landing* (EYG No. AU3725), is designed to help entities understand the business impacts of the new standard. Refer to that publication for further information about the impacts of the standard and the steps entities should be taking to apply it.

The views we express in this publication are preliminary as of February 2017. We may identify additional issues as we analyse IFRS 16 and entities begin to interpret it, and our views may evolve during that process.

1. Key considerations

1.1 Scope and scope exclusions

IFRS 16 applies to leases of all assets, except for the following:

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources
- Leases of biological assets held by a lessee
- Service concession arrangements
- Licences of intellectual property granted by a lessor
- Rights held by a lessee under certain licensing agreements (e.g., motion picture films, patents and copyrights)

A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets other than those described above.

Consistent with IAS 17, leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources are excluded from the scope of IFRS 16. Likewise, entities will need to apply judgement to determine how broadly to interpret and apply this scope exclusion.

IFRS 16 does not specify whether the scope exclusion for leases to explore for or use minerals, oil, natural gas and similar non-regenerative resoures applies broadly to other leases that relate to, or are part of, the process of exploring for, or using, those resources. For example, in some jurisdictions, the resources are owned by the government, but the land within which the resources are located is privately owned. In these jurisdictions, an oil and gas entity needs to enter into a petroleum or resources lease with the government as well as a surface lease (i.e., the right to use the land) with the private landowner. IFRS 16's Basis for Conclusions states that IFRS 6 *Exploration for and Evaluation of Mineral Resources* specifies the accounting for rights to explore for, and evaluate, mineral resources.[1]

Today, oil and gas entities generally apply the similar IAS 17 scope exclusion to surface leases that are directly related to resource rights. However, they do not interpret the exclusion to extend to leases of equipment used in exploration and evaluation (E&E) activities, or to leases of equipment entered into during the development and production phases. The new US GAAP leases standard (ASC 842 *Leases*), includes more specific guidance on how this scope exclusion should be applied. It states that leases of minerals, oil, natural gas and similar

[1] IFRS 16.BC68(a)

non-regenerative resources, including the intangible rights to explore for those resources and the rights to use the land in which those natural resources are contained (unless those rights of use include more than the right to explore for natural resources) are outside the scope of ASC 842. However, equipment used to explore for the natural resources is within the scope of ASC 842.[2]

IFRS 16 is not specific as to whether the scope exclusion only applies to resources rights in the E&E phase or whether it also applies to other rights (e.g., exploitation and/or extraction rights that arise in connection with development and production phases). The wording of the exclusion specifies that it applies to "leases to explore for **or use** minerals" (emphasis added), which suggests that it applies more broadly (i.e., to the E&E, development and production phases). However, the reference to IFRS 6 in the Basis for Conclusions of IFRS 16[3] suggests that the exclusion is limited to rights in the E&E phase. Today, oil and gas entities generally apply the IAS 17 scope exclusion to the mineral rights in the E&E, development and production phases.

How we see it

Similar to today, entities will need to exercise judgement to determine which arrangements are in the scope of IFRS 16, especially those related to petroleum rights. However, the impact on the balance sheet and the income statement will be more significant under IFRS 16 than under today's requirements.

1.2 Definition of a lease

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), 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. To be a lease, a contract must convey the right to control the use of an identified asset.

A wide variety of arrangements exist in the oil and gas sector that may provide a right to control the use of an identified asset(s). Some examples include: oil and gas services contracts such as drilling contracts; use of pipelines, floating (production) storage and offtake vessels; shipping, freight and other transportation arrangements; processing, tolling and refining arrangements; and storage arrangements (including capacity portions of such arrangements). Also, while not specific to the oil and gas sector, there are other arrangements commonly entered into by oil and gas entities that will also need to be considered. These arrangements include outsourcing arrangements, such as IT; and utility supply arrangements, such as those for the purchase of gas, electricity, water or telecommunications. Today, these may be accounted for as service contracts instead of leases, and the treatment will need to be reassessed in light of the requirements of IFRS 16.

1.2.1 Identified asset

The concept of an identified asset is generally consistent with the 'specified asset' concept in IFRIC 4. Under IFRS 16, an identified asset can be either implicitly or explicitly specified in a contract and can be a physically distinct portion of a larger asset (e.g., a pipeline that connects a single customer to a larger pipeline or a specific storage tank at a storage terminal).

[2] ASC 842-10-15-1
[3] IFRS 16.BC68(a)

Entities will need to carefully evaluate, at inception of the contract, whether the supplier's substitution rights, if any, are substantive.

Some oil and gas entities enter into arrangements for the right to use a portion of an asset's capacity, such as arrangements for storage capability, where a portion of a storage tank is used, or for transportation, where a portion of a pipeline's capacity is used. A capacity portion of an asset that is less than substantially all of that asset's capacity would not be an identified asset because it is not physically distinct from the remaining capacity of the asset. However, a capacity agreement that provides the oil and gas entity with the right to use substantially all of the capacity of an asset (e.g., a gas processing plant or pipeline), may be an identified asset. Determining whether a capacity arrangement contains an identified asset will require judgement.

Even if an asset is specified, there is no identified asset if, at the inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use. A substitution right is substantive if the supplier has the practical ability to substitute alternative assets throughout the period of use and the supplier would benefit economically from exercising its right to substitute the asset.

Oil and gas entities enter into a variety of arrangements that will need to be evaluated to determine whether they involve the use of an identified asset, and, whether there is a substantive right of substitution. For example, a contract with a shipping contractor for the use of an oil tanker may specify the exact vessel to be used in the provision of the shipping services, and the vessel may be identified in the contract. Alternatively the contract may provide for the provision of an oil tanker of a specified size, without naming a specific asset in the contract. Whether, in each circumstance, there is an identified asset will depend on whether an asset is explicitly or implicitly specified in the contract and whether rights of substitution, if any, are considered substantive.

If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer presumes that any substitution right is not substantive.

In some cases, determining whether there is an identified asset can be relatively straightforward. However, in other cases, this assessment may require judgement. This may be the case for arrangements involving transportation or storage. Entities will need to carefully evaluate, at inception of the contract, whether the supplier's substitution rights, if any, are substantive. For example, the supplier's substitution rights may not be substantive if: (1) alternative assets are not readily available to the supplier or they could not be sourced by the supplier within a reasonable period of time and, hence, there is no practical ability to substitute them; or (2) the asset is highly customised and/or significant costs have been incurred to ensure the asset meets the specifications required by the contract such that the supplier would not benefit economically from exercising its substitution right.

1.2.2 Right to control the use of the identified asset

A contract conveys the right to control the use of an identified asset for a period of time if, throughout the period of use, the customer has both of the following:

- The right to obtain substantially all of the economic benefits from the use of the identified asset
- The right to direct the use of the identified asset

A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the asset). Economic benefits include the asset's primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits that are generated through its use), including potential cash flows derived from these items. Economic benefits also include those from using the asset that could be realised from a commercial transaction with a third party (e.g., subleasing the asset). However, economic benefits arising from ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits), are not considered economic benefits derived from the use of the asset.

A customer has the right to direct the use of an identified asset throughout the period of use, when either:

(a) The customer has the right to direct how and for what purpose the asset is used throughout the period of use

Or

(b) The relevant decisions about how and for what purpose the asset is used are predetermined and the customer either:

i. Has the right to operate the asset, or 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

ii. Has 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

When evaluating whether a customer has the right to direct how and for what purpose the asset is used throughout the period of use, the focus is on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract. The standard also requires that, if the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

IFRS 16 provides examples of the decision-making rights that, depending on the circumstances, may provide the customer with the right to direct how and for what purpose the asset is used, within the defined scope of the customer's right of use. Examples include: (1) the right to change the type of output produced by the asset; (2) when the output is produced; (3) where the output is produced; and (4) whether the output is produced and the quantity of the output.

The determination of which party directs the use of the underlying asset may require judgement.

Evaluating whether the customer (i.e., the oil and gas entity), controls the use of an identified asset will be straightforward in most arrangements. However, evaluating other arrangements will require more judgement. In certain types of contracts (such as for oil and gas services), both the oil and gas entity and the supplier may have some involvement in deciding how and for what purpose the asset is used. Therefore, the determination of which party directs the use of the underlying asset may require judgement.

For example, in an oil and gas services contract, the oil and gas entity (i.e., customer) may have the right to direct when, where and how the drilling equipment is used, and have the ability to change those decisions. The supplier may have the right to determine whether conditions are safe for operation. The supplier's right would be considered a protective right, which, in isolation, is not a decision that most significantly affects the economic benefits derived from the drilling equipment throughout the period of use. Therefore, the oil and gas entity may have the right to direct the use of the identified asset.

1.2.3 Transition relief

IFRS 16's transition requirements are discussed in detail in the *General Applying IFRS*. Among other transition relief provided, lessees and lessors will be permitted to make an accounting policy election on initial application of IFRS 16, not to reassess whether contracts are, or contain, leases, provided the requirements of IFRIC 4 have been properly applied. That means that, at the date of initial application of IFRS 16, an entity may elect to apply its current assessment under IFRIC 4 of whether or not its contracts are, or contain, leases. This is only applicable for contracts entered into before the date of initial application of IFRS 16.

How we see it

- Because accounting for operating leases under IAS 17 and accounting for service contracts is similar, determining whether an arrangement is a lease or a service contract may not have been a focus for many entities. Under IFRS 16, the difference between accounting for an arrangement as a service contract and a lease could be material. This may require some entities to focus more than they have in the past on determining whether arrangements are, or contain, a lease.

- Determining whether the oil and gas entity directs the use of an identified asset within some service contracts could be complex. However, the focus will need to be on which entity has the right to make the decisions that most significantly affect the economic benefits that can be derived from the use of the underlying asset.

1.3 Arrangements entered into by joint arrangements

Oil and gas entities often enter into joint arrangements and these are effected by a joint operating agreement with other entities. A contract for the use of an asset by a joint arrangement might be entered into in a number of different ways, including:

- Directly by the joint arrangement, if the joint arrangement has its own legal identity

- By each of the parties to the joint arrangement (i.e., the operator and the other parties, commonly referred to as the non-operators) individually signing the same arrangement

- By one or more of the parties to the joint arrangement on behalf of the joint arrangement. Generally, this would be evidenced in the contract and the parties to the joint arrangement would have similar rights and obligations as they would if they individually signed the arrangement. In these situations, the facts and circumstances, as well as the legal position of each entity, need to be evaluated carefully.

- By the operator of the joint arrangement in its own name, i.e., as principal. This may occur where the operator leases equipment which it then uses in fulfilling its obligations as operator of the joint arrangement and/or across a range of unrelated activities, including other joint arrangements with unrelated activities, such as with other joint operating parties.

IFRS 16 states that where a contract has been entered into by a joint arrangement, or on behalf of the joint arrangement, the joint arrangement is considered to be the customer in the contract.[4] Accordingly, in determining whether such a contract contains a lease, an assessment needs to be made as to which party (e.g., the joint arrangement or the operator) has the right to control the use of an identified asset throughout the period of use.

If the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use as a result of their collective control of the operation, the joint arrangement is the customer to the contract that may contain a lease. It would be inappropriate to conclude that the contract does not contain a lease on the grounds that each of the parties to the joint arrangement either has rights to a non-physically distinct portion of an underlying asset and, therefore, obtains only a portion of the economic benefits from the use of that underlying asset or does not unilaterally direct its use. Determining if the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use would require a careful analysis of the rights and obligations of each party.

In the first three scenarios above, if it has been determined that a contract is, or contains, a lease, where the joint arrangement was classified as a joint operation, each of the parties to the joint arrangement (i.e., the joint operators comprising the operator and the non-operators) will account for their respective interests in the joint arrangement (including any leases) under paragraphs 20-23 of IFRS 11 *Joint Arrangements*. Therefore, they will account for their individual share of any right-of-use assets and lease liabilities, and associated depreciation and interest.

In the final scenario (i.e., where the operator enters the arrangement in its own name), the operator will need to assess whether the arrangement is, or contains, a lease. If the operator controls the use of the identified asset, it would recognise the entire right-of-use asset and lease liability on its balance sheet. This would be the case even if it is entitled to bill the non-operator parties their proportionate share of the costs under the joint operating agreement.

If the operator determines it is the lessee, it would also evaluate whether it has entered into a sublease with the joint arrangement (as the customer to the sublease). For example, the operator may enter into a five-year equipment lease with a supplier, but may then enter into a two-year arrangement with one of its joint arrangements, thereby yielding control of the right to use the equipment to the joint arrangement during the two-year period. The conclusion as to whether the joint arrangement is a customer, i.e., the lessee in a contract with an operator, by virtue of the joint operating agreement, would be impacted by the individual facts and circumstances.

If there is a sublease with the operator, the non-operators would recognise their respective share of the joint operation's lease right-of-use asset and lease liablity and the operator would have to account for its sublease to the joint arrangement separately. However, if no sublease existed, the non-operators would recognise joint interest payables when incurred for their share of the costs incurred by the operator in respect of the leased asset.

---

[4] IFRS 16.B11

Depending on the conclusions reached, an operator may observe differences in the recognition patterns in profit or loss between the head lease costs (which will have more of a front-loaded expense profile) and the income received from billing the non-operators (either through a sublease or joint interest billings).

How we see it

- Evaluating the requirements of IFRS 11 and IFRS 16 for joint arrangements will involve judgement and consideration of the legal implications of the contractual arrangements in place. As entities continue to evaluate the impact of such requirements, interpretations may evolve.
- Entities may also need to exercise judgement in determining how to disclose information about leases that will be meaningful to financial statement users, particularly when they are operators of some leased assets and non-operators of other assets for which they may recognise their share of a sublease and/or recognise joint interest payables for activities performed by the operator using leased assets.

1.4 Identifying and separating lease and non-lease components and allocating contract consideration

For contracts that contain the rights to use multiple assets (e.g., a building and equipment or multiple pieces of equipment), the right to use each asset is considered a separate lease component if both of the following apply: (1) the lessee can benefit from the use of the underlying asset, either on its own or together with other resources that are readily available to the lessee; and (2) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. For example, the lease contract for an office building and an adjacent land parcel to be used for future development by the lessee will generally be considered to contain two lease components because the lessee could benefit from the office building without development of the adjacent land parcel.

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). Examples of contracts that may contain a lease and significant non-lease components for services provided by the supplier include:

- Processing, transportation and storage contracts, which generally require the supplier to operate the facilities
- Outsourced oil and gas services contracts
- Drilling contracts, which typically include operation services

Judgement may be required to identify lease and non-lease components.

For these contracts, the non-lease components are identified and accounted for separately from the lease component, in accordance with other standards. For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to IFRS 15 by lessors (suppliers).

IFRS 16 provides a practical expedient that permits lessees to make an accounting policy election, by class of underlying asset, to account for each separate lease component of a contract and any associated non-lease components as a single lease component.

Lessees that do not make an accounting policy election to use this practical expedient are required to allocate the consideration in the contract to the lease and non-lease components on a relative stand-alone price basis. Lessees are required to use observable stand-alone prices (i.e., prices at which a customer would purchase a component of a contract separately) when available. If observable stand-alone prices are not readily available, lessees should estimate stand-alone prices, maximising the use of observable information.

Lessors do not have a practical expedient to account for lease and non-lease components as a single lease component. Lessors are required to apply IFRS 15 to allocate the consideration in a contract between the lease and non-lease components, generally, on a relative stand-alone selling price basis. The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. When stand-alone selling prices are not directly observable, the lessor must estimate them. IFRS 15 provides suitable methods for doing this.

How we see it

Identifying non-lease components of contracts (e.g., oil and gas services arrangements) may change practice for some lessees in the oil and gas sector. As most leases are recognised on lessees' balance sheets under IFRS 16, lessees may need to put more robust processes in place to identify the lease and to separate the lease and non-lease components of contracts.

2. Lease classification

Under IFRS 16, lessees apply a single accounting model for all leases, with options not to recognise short-term leases and leases of low-value assets on the balance sheet. See sections **3.1 Short-term leases recognition exemption** and **3.2 Leases of low-value assets recognition exemption** for more detail.

Lessors, however, classify all leases in the same manner as under IAS 17, distinguishing between two types of leases: finance and operating. Lessors are required to reassess lease classification upon a modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of its original terms and conditions) that does not result in a separate lease.

3. Lessee accounting

At the commencement date of a lease, a lessee recognises a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset).

Lessees measure the lease liability using the interest rate implicit in the lease, if that rate is readily determinable. If that rate cannot be readily determined, the lessee is required to use its incremental borrowing rate. Lessees measure the right-of-use asset at the amount of the lease liability, adjusted for lease prepayments, lease incentives received, the lessee's initial direct costs (e.g., commissions) and an estimate of restoration, removal and dismantling costs.

Lessees are required to separately recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset. When the right-of-use asset is depreciated on a straight-line basis, this will generally result in a front-loaded expense recognition pattern, which is consistent with the subsequent measurement of finance leases under IAS 17.

Appendix A sets out an example of lessee accounting.

How we see it

The requirement that lessees recognise assets and liabilities for most leases will impact both their balance sheet and statement of profit or loss. Lessees' debt and equity ratios are likely to be affected by the gross-up of their balance sheets. Operating lease expense under IAS 17 is replaced by depreciation and interest expense. This will affect some performance measures, such as EBIT or EBITDA, that are key for almost all oil and gas companies, but may also affect other performance measures, such as interest cover, depending on the characteristics of the lease portfolio and the effects on the expense recognition pattern.

This could influence commercial leasing decisions and strategies of oil and gas entities. For example, some lessees may make different decisions about whether to lease or purchase an asset. In addition, some lessees may seek to negotiate lease terms with greater variable payments (not based on an index or rate) or fewer years than they do currently in order to reduce the balances of recorded assets and liabilities. Many factors will influence a lessee's decisions, including but not limited to, the nature of its business, its business requirements, the economics of leasing versus buying, debt and equity covenant restrictions and access to capital.

3.1 Short-term leases recognition exemption

Lessees can make an accounting policy election, by class of underlying asset to which the right of use relates, to apply accounting similar to IAS 17's operating lease accounting to leases that, at the commencement date, have a lease term of 12 months or less and do not include an option to purchase the underlying asset (short-term leases). If a lessee applies this exemption, short-term leases are not recognised on the balance sheet and the related lease expense is recognised on a straight-line basis over the term of the lease or another systematic basis, if that basis is more representative of the pattern in which the benefits from the use of the underlying asset are diminished.

3.2 Leases of low-value assets recognition exemption

Lessees can also make an election, on a lease-by-lease basis, to apply accounting similar to current operating lease accounting to leases for which the underlying asset is of low value (low-value assets). To be a low-value asset, a lessee must be able to benefit from the asset either on its own or together with other resources that are readily available to the lessee. In addition, a low-value asset must not be highly dependent on, or highly interrelated with, other assets. At the time of reaching its decisions about the exemption, the IASB had in mind leases of underlying assets with a value, when new, of US$5,000 or less.

4. Lessor accounting

IFRS 16 requires lessors to account for operating leases using an approach that is substantially unchanged from IAS 17. That is, lessors continue to recognise the underlying asset, and lease payments are recognised as income over the lease term, either on a straight-line basis or another systematic basis that is more representative of the pattern in which the benefits from the use of the underlying asset are diminished.

Under IFRS 16, lessors are also required to account for finance leases using an approach that is substantially unchanged from IAS 17. That is, lessors will derecognise the carrying amount of the underlying asset, recognise a receivable equal to the net investment in the lease and recognise, in profit or loss, any selling profit or loss.

Sale and leaseback transactions will no longer provide lessees with a source of off-balance sheet financing.

5. Other considerations

5.1 Sale and leaseback transactions

Because lessees are required to recognise most leases on the balance sheet (i.e., all leases except for short-term leases and leases of low-value assets if the lessee makes accounting policy elections to use those exemptions), sale and leaseback transactions will no longer provide them with a source of off-balance sheet financing.

IFRS 16 requires seller-lessees and buyer-lessors to apply the requirements in IFRS 15 to determine whether a sale and purchase has occurred in a sale and leaseback transaction. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale and purchase by both parties. If not, the transaction is accounted for as a financing by both parties.

How we see it

The new requirements are a significant change from current practice for seller-lessees. Under IFRS 16, seller-lessees must apply the requirements in IFRS 15 to determine whether a sale has occurred. Also, even if the criteria for a sale have been met, sale and leaseback transactions, generally, would no longer lead to an off-balance sheet financing.

6. Next steps

- Entities should perform a preliminary assessment as soon as possible to determine how their lease accounting will be affected. Critical first steps include: (1) identifying the sources and locations of an entity's lease and service contract data; and (2) accumulating that data in a way that will facilitate the application of IFRS 16. This should include evaluating agreements that are or may contain lease components, particularly drilling contracts, other service contracts that provide for the use of equipment by the oil and gas entity, transportation or capacity arrangements, storage agreements and land, building and equipment rental contracts. For entities with decentralised operations (e.g., an entity that is geographically dispersed), this could be a complex process, given the possibility for differences in operational, economic and legal environments.

- Entities should consider future enhancements to current processes, including internal controls and systems, to enable collection of the information necessary to implement IFRS 16 (including making the necessary financial statement disclosures). This may involve a need for commercial, operational, technical and procurement personnel to understand how arrangements may fall into or outside of the scope of IFRS 16, to assist with identification and assessment of all lease arrangements.

- Having an early understanding of the potential implications will be beneficial in managing the process of negotiating future contracts, particularly those long-term contracts that will still be in effect at transition date. It will also be essential for entities to take the time to understand fully the changes so they can assess the impact on their businesses and to keep key stakeholders informed of the implications. Such stakeholders would include audit committees, boards, auditors, shareholders, analysts and other users.

Appendix A: Lessee accounting example

Illustration 1 — Lessee accounting

Best Petroleum Inc. (lessee) enters into a three-year contract with Best Pipeline Inc. (lessor) for the right to use all of the capacity in a gas processing facility over this period. Best Petroleum Inc. agrees to make the following annual payments at the end of each year: CU10,000 in year one, CU12,000 in year two and CU14,000 in year three. For simplicity, there are no other elements to the lease payments (e.g., purchase options, lease incentives from the lessor or initial direct costs). The initial measurement of the right-of-use asset and lease liability is CU33,000 (present value of lease payments using a discount rate of 4.235%). Best Petroleum Inc. uses its incremental borrowing rate as the discount rate because the rate implicit in the lease cannot be readily determined. Best Petroleum Inc. depreciates the right-of-use asset on a straight-line basis over the lease term.

Analysis: At lease commencement, Best Petroleum Inc. would recognise the lease-related asset and liability in a manner similar to what it would do today under a finance lease:

Right-of-use asset	CU	33,000		
Lease liability			CU	33,000

To initially recognise the lease-related asset and liability

The following journal entries would be recorded in the first year:

Interest expense	CU	1,398		
Lease liability			CU	1,398

To record interest expense and accrete the lease liability using the interest method (CU33,000 x 4.235%)

Depreciation expense	CU	11,000		
Right-of-use asset			CU	11,000

To record depreciation expense on the right-of-use asset (CU33,000 ÷ three (3) years)

Lease liability	CU	10,000		
Cash			CU	10,000

To record lease payment

A summary of the lease contract's accounting (assuming no changes due to reassessment) is, as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments		CU 10,000	CU 12,000	CU 14,000
Lease expense recognised				
Interest expense		CU 1,398	CU 1,033	CU 569
Depreciation expense		CU 11,000	CU 11,000	CU 11,000
Total periodic expense		CU 12,398	CU 12,033	CU 11,569
Balance sheet				
Right-of-use asset	CU 33,000	CU 22,000	CU 11,000	CU –
Lease liability	(CU33,000)	(CU24,398)	(CU13,431)	CU –

Immaterial differences may arise in the computation of amounts in the example above due to rounding.

EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

How EY's Global Oil & Gas Sector can help your business

The oil and gas sector is constantly changing. Increasingly uncertain energy policies, geopolitical complexities, cost management and climate change all present significant challenges. EY's Global Oil & Gas Sector supports a global network of more than 10,000 oil and gas professionals with extensive experience in providing assurance, tax, transaction and advisory services across the upstream, midstream, downstream and oil field subsectors. The Sector team works to anticipate market trends, execute the mobility of our global resources and articulate points of view on relevant sector issues. With our deep sector focus, we can help your organization drive down costs and compete more effectively.

EYG No. 00698-173Gbl

EY-000022911.indd (UK) 02/17. Artwork by CSG London.

ED None

ey.com