VIEWPOINTS:
Applying IFRS® in the Oil and Gas Industry

IFRS 16 LEASES – KEY RECOGNITION CONSIDERATIONS FOR THE OIL AND GAS INDUSTRY

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Oil and Gas Industry Task Force on IFRS Standards

International Financial Reporting Standards (IFRS®) create unique challenges for junior oil and gas entities. Financial reporting in the sector is atypical due to significant differences in characteristics between junior oil and gas entities and other types of entities. The Canadian Association of Petroleum Producers (CAPP), the Explorers and Producers Association of Canada (EPAC) and the Chartered Professional Accountants of Canada (CPA Canada) created the Oil and Gas Industry Task Force on IFRS Standards to share views on IFRS Standards application issues of relevance to junior oil and gas entities. The views of the Task Force are provided in a series of papers available through free download. These views are of particular interest to chief financial officers, controllers and auditors.

Background

IFRS 16, *Leases*, is the new standard that sets out the principles for the recognition, measurement, presentation and disclosure of leases.

This *Viewpoint* outlines some key issues to consider for recognition of leases in contractual arrangements common to the oil and gas industry, and focuses primarily on the recognition of leases from a lessee perspective. This *Viewpoint* does not consider transition or lessor accounting issues nor is it intended to be exhaustive. There are other issues financial statement preparers will need to consider when evaluating the impact of IFRS 16 on their financial statements.

This *Viewpoint* only reflects standards effective as of the date of this *Viewpoint* and does not consider recent decisions and ongoing discussions of the IFRS Interpretations Committee.

Under IFRS 16, a contractual arrangement is (or contains) a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Control exists when the lessee has both the right to direct the use of the asset and obtains substantially all its economic benefits during the period of use.

CPA CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

CAPP CANADIAN ASSOCIATION OF PETROLEUM PRODUCERS

EPAC THE EXPLORERS AND PRODUCERS ASSOCIATION OF CANADA

IFRS 16 requires companies to record a right-of-use asset and lease liability for almost all leases, with limited exceptions. On the asset side, the right-of-use asset is measured at cost and amortized over the term of the lease. On the liability side, the lease liability is measured at the present value of future lease payments and amortized over the lease term. As such, after initial recognition, the values of the lease asset and lease obligation will generally not match. Depending on the number and size of operating leases, this discrepancy may significantly increase a company's assets and liabilities as recorded in its balance sheet.

Under IFRS 16, the expense related to a lease is comprised of the depreciation of the right-of-use lease asset and the accretion of the lease liability. This will normally differ from the expense related to a lease determined under previous GAAP (IAS 17, *Leases*).

Issue

Certain contractual arrangements common to the oil and gas industry will likely be impacted by IFRS 16. Key lease recognition issues in the oil and gas industry included in this *Viewpoint* are:

- mineral leases and surface-land-use contracts
- lateral pipeline use agreements
- master lease agreements covering multiple assets
- short-term leases and leases of low-value items
- identifying leases embedded in services contracts
- lease and non-lease components of contracts
- discount rate

Viewpoints

Mineral Leases and Surface-Land-Use Contracts

In many jurisdictions, prior to the exploration and development of oil and natural gas, an entity must enter into both a mineral rights agreement (commonly referred to as a "mineral lease") with the mineral rights owner as well as into a surface-land-use agreement (commonly referred to as a "surface lease") with the landowner, who may be a government body or private owner. IFRS 16 contains a specific scope exemption for "leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources." IFRS 16 does not specify whether this scope exemption applies strictly to leases for mineral access rights or extends to leases related to the initial mineral lease. Such related leases may include leases of surface land overlying the mineral lease as well as surface land leases initiated for pipelines and facilities necessary for the extraction of oil and natural gas.

Professional judgment will be required to determine how broadly to interpret and apply this scope exemption. For example, it is unclear whether a surface lease for the extraction site might be excluded from the requirements of IFRS 16 under the scope exemption. However, in the event the lease rights extend to more than purely the right to explore for or use the natural resources (e.g., placing a corporate head office or processing facility on the same land), a portion of the lease might not be exempted.

Lateral Pipeline Use Agreements

Pipelines operate integrated networks to transport natural gas, oil and refined products from supply regions to demand regions. Some customers are connected to the main pipeline system through dedicated lateral pipelines in order to send or receive deliveries of transported commodities.

Customers connected to a lateral pipeline enter into arrangements with the pipeline operator for transportation services through the network to their connection point. These arrangements must be assessed to determine whether they contain leases of the lateral, first mile or last mile of the pipeline system.

Because lateral pipelines are usually separately identifiable assets, the assessment of whether the assets' contractual use constitutes a lease must focus on whether the customer has the right to control the asset during the contract term. Generally, there are two types of lateral pipeline agreements:

1. **Type 1 (the most common):** A lateral pipeline is connected to an integrated pipeline system which cannot be operated on a stand-alone basis and must share supply sources with the main line and other customers of the pipeline operator. The pipeline operator retains the right and can change the compression in the lateral to manage pressure in the lateral and on the main system. Additionally, the pipeline operator retains the right to store its own commodity in the lateral ("line pack").

   In this scenario the pipeline operator retains the:

   - economic benefits from the asset's use by retaining rights to both the lateral's storage capacity and an ability to manipulate the lateral's compression levels to manage the pressure in the larger system
   - right to direct the use of the asset throughout the contract term by retaining the right to amend the timing and extent of the customer's use of the lateral based on the needs of the main pipeline system

   Depending on the significance of rights retained by the pipeline operator, this type of pipeline lateral agreement is generally more difficult to substantiate that the customer has obtained control of the asset. As a result, it does not generally constitute a lease.

2. **Type 2:** Under this second type of arrangement, lateral pipelines "are fully capable of operating using their own dedicated assets," and "the customer has the right to substantially all the pipeline lateral's capacity." These contracts allow the customer to close off the lateral from the remainder of the pipeline system (by closing a valve or a similar mechanism), thus preventing the pipeline owner from directing the use of the asset. The additional rights afforded to the customer in this type of arrangement suggest more control over the lateral pipeline asset, which could suggest the existence of a lease.

Master Lease Agreements Covering Multiple Assets

Oil and natural gas producers will sometimes execute master lease agreements with a supplier that establish the terms and conditions of a contract governing the use of multiple leased assets. In addition to assets under lease at the inception of the agreement, some master lease agreements may allow the lessee to gain control over the use of additional assets during the contract term. In this situation, the lessee must exercise judgment as to what amount is appropriate for recognition at the inception of the lease. This will likely depend on specific provisions within the agreement, such as whether the contract commits the lessee to gain control of a minimum quantity of underlying assets.

A master use agreement may also contain multiple lease commencement dates, because a master lease agreement may cover a significant number of underlying assets that are each made available for use by the lessee on different dates.

In a manner consistent with how an entity determines the commencement date for a single lease, an entity must determine the commencement date for each underlying asset leased under a master lease agreement. This should be based on the date each underlying asset is made available for use to the lessee.

Short-Term Leases and Leases of Low-Value Items

IFRS 16 includes separate recognition exemptions available to lessees for both short-term leases and leases of low-value items. Judgment will be required to conclude whether the exemptions apply to individual leases.

A short-term lease is defined as a "lease that, at the commencement date, has a lease term of 12 months or less." While this is a clear definition, companies will nevertheless have to assess the effect of extension and termination options included in a lease agreement to determine whether it qualifies as a short-term lease. Additionally, regardless of the lease term, a lease that contains a purchase option cannot be classified as a short-term lease.

Lessees may choose not to apply IFRS 16 to contracts for assets of low value. This exemption is intended as a practical expedient when accounting for low-value items. It is noted that this exemption is not available for leases of assets highly dependent on, or highly interrelated with, other assets which, when used as intended, would not be considered low-value assets.

While IFRS 16 does not specify a value threshold, the Basis for Conclusions suggests a threshold of approximately US$5,000 per asset when new was considered for the exemption. No specific dollar value was included in IFRS 16 due to the potential effects of foreign exchange and inflation; however, this dollar threshold should be considered when applying this optional exemption. In practice, determining whether items are of "low value" may be challenging, given that the guidance is limited. For instance, the Basis for Conclusions to IFRS 16 cites tablets, personal computers, office furniture and telephones as examples.

The election for exemption of short-term leases must be made by class of underlying asset, whereas the election for exemption of leases for which the underlying asset is of low value can be made on a lease-by-lease basis. Though both short-term leases and leases of low-value items are exempt from the balance sheet recognition requirements of IFRS 16, the standard requires disclosure of the expense associated with short-term leases (excluding leases of one month or less) and low-value leases. Accordingly, financial statement preparers will need to identify and track such leases to facilitate financial statement disclosures.

Identifying Leases Embedded in Services Contracts

A contract contains a lease when the contract conveys the right to direct the use of an identified asset and obtain substantially all the economic benefits from the asset during the period of use in exchange for consideration. Many contracts which oil and gas entities might previously have considered to be service contracts may include leases of equipment within the contract. This occurs when there is an identified asset(s) explicitly or implicitly included in the contract and the oil and gas entity has the ability to control that asset(s) during the contract term. Financial statement preparers should carefully review existing and new service contracts to determine whether they contain a lease required to be recognized under IFRS 16.

Identified asset

Paragraph B13 of the Basis for Conclusions for IFRS 16 states that “an asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer.” For instance, if a serial or identification number of the asset is included in the contract, the asset is explicitly specified. If the supplier, however, has the substantive right to substitute the asset for another asset, the asset is not an identified asset and, therefore, most likely not a lease. A supplier’s substitution right is “substantive” if the supplier has the practical ability to substitute the asset throughout the period of use and would benefit economically from exercising its right to substitute the asset.

For example, Oil Inc. may contract a third party to transport oil by rail. If the contract allows the transportation company to use any railcar from its fleet of railcars to ship production to a sales point, or the transportation company has a substantive substitution right in the contract, it is most likely not an identified asset and, therefore, probably not a lease.

Assets do not need to be explicitly specified in the contract to qualify as an identified asset. The key test is whether the asset is specified at the time it is made available to the customer. For example, Oil Inc. may enter into a contract for drilling services in a remote oil field for a two-year period. The contract specifies that the driller must provide an appropriate drill rig to complete the services but does not specify the exact rig or a specific type of rig. The driller may have several potential rigs available to fulfill the contract, any of which could be transported to the site. However, from a practical perspective, it may be likely that once a specific drill rig is transported to the site, it is the only rig that will be used to fulfill the contract. Though the contract did not explicitly identify the asset to be used, the individual drill rig might have to be viewed as an implicitly specified identified asset when it is made available to Oil Inc. and, therefore, may require further assessment under IFRS 16.

The capacity portion of an asset may be an identified asset if it is physically distinct. For example, office space that consists of a specific floor or a specific part of a floor of an office building is physically distinct. As such, each specific floor or specific part of a floor may be viewed as an identified asset.

A capacity portion of an asset that is not physically distinct is not an identified asset. For example, Oil Inc. enters into a five-year contract with Terminal Co. for the right to store oil at Terminal Co.'s terminal. The contract provides that Oil Inc. will have the right to the use of 60% of a specified tank's capacity throughout the term of the arrangement. Terminal Co. can use the other 40% of the capacity of that tank to store oil for other customers. In this example, Oil Inc. most likely has no identified asset because it only has rights to 60% of the specified tank's storage capacity, and that capacity portion is neither physically distinct from the remainder of the tank's storage capacity nor "substantially all" of the tank.

Key considerations when determining whether or not the contract includes an identified asset may include, but are not limited to, the following:

- Is an asset or type of asset specifically identified in the contract?
- Will the supplier be required to provide certain assets for the duration of the contract to fulfill the contract?
- Does the supplier have a substantive substitution right?[1]
- Once an asset is made available to the oil and gas entity (i.e., brought to site), is substitution logistically feasible and economically beneficial?[2]

Control

Control of an asset requires both the right to obtain substantially all the economic benefits during the term and the right to direct the asset's use.

When considering the economic benefits, only those economic benefits obtained during the lease term are considered. If the lease term is only for a portion of the economic life of the asset, only that portion under contract is considered. For example, if Oil Inc. has exclusive rights to use a haul truck for two years but the haul truck has a life of 10 years, Oil Inc. appears to have the right to obtain substantially all the economic benefits for the two-year term and the contract likely contains a lease for those two years. The economic life outside the contract term is not relevant to the lease assessment.

When determining control over the asset, the rights to direct how and for what purpose the asset is used throughout the period of use are considered. If the use of the asset, however, is predetermined and the customer either has the right to operate the asset or has designed the asset in such a way that predetermines its use, then the customer may be deemed to direct the use of the asset.

1 The supplier having the ability or requirement to substitute an asset only for maintenance or repair is not considered to have a substantive substitution right.

2 The concept of "economically beneficial" is different when compared with IFRIC 4, *Determining Whether an Arrangement Contains a Lease*, which requires that substitution be economically feasible. IFRS 16 has a higher threshold for substitution rights than the previous standard.

IFRS 16 includes examples of rights that, depending on the circumstances, grant the right to change how and for what purpose the asset is used within the defined scope of the customer's right of use. These include rights to change:

- the type of output produced by the asset (e.g., to decide whether to use a haul truck to move waste)
- when the output is produced (e.g., to decide when an item of machinery or a plant will be used)
- where the output is produced (e.g., to decide upon the destination of a truck or a railcar, or to decide where an item of equipment is used)
- whether the output is produced and the quantity of that output (e.g., to decide whether to use the asset to produce)

Decisions limited to operating or maintaining the asset generally do not convey the right to use the asset.

For example, in the case of a drilling contract, where the customer has the right to decide the location of the drill rig and the targets to be drilled, and the drilling company is in charge of providing the drill rig and managing operations and maintenance, these factors suggest that the customer's rights to determine the strategic use of the drill rig would typically result in the customer directing the use of the drill rig. However, making that assessment will require the oil and gas entity to assess all the facts and circumstances before coming to that conclusion.

Other indicators of the customer directing the use of a drill rig may include the customer's right to determine when to use or not to use the drill rig or pay the operator a "stand-by" fee when the drill rig is not in use. If the drilling company cannot use the drill rig elsewhere (i.e., does not have a substantive substitution right), the stand-by fee would typically meet the definition of a lease payment, as it is an in-substance fixed payment representing the minimum unavoidable commitment by the customer to the drilling company. Stand-by commitments are generally expressed in a specific number of drilling days. If the committed number of drilling days is expected to be used up in 12 months or less, the entity will have to consider whether it can apply the optional short-term exemption.

See Appendix for a flow chart illustrating whether a contract contains a lease.

Lease and Non-Lease Components of Contracts

In many cases, a contract may contain both a lease of an asset and a service being provided. A drilling contract generally contains both a drill rig and an operating crew. If the use of the drill rig is determined to be a lease, the portion of the contract pertaining to the drill rig must be separated from the service portion of the contract (i.e., the services of an operating crew) unless the practical expedient described further below is used.

A portion of the contract cost should generally be allocated to the lease component based on the proportionate value of the lease and service components of the contract.[3]

Charges for administrative tasks and other costs (e.g., insurance) associated with the lease that do not transfer a good or service to the oil and gas entity are not a separate component. They are, however, part of the consideration to be allocated to the lease and service components of the contract.

IFRS 16 includes a practical expedient whereby a lessee can make an accounting policy choice by class of underlying asset not to separate lease and non-lease components. If this practical expedient is elected, the oil and gas entity accounts for the entire contract as a lease. The Task Force notes that, to the extent there are fixed payments allocated to non-lease components, this practical expedient increases the right-of-use asset and associated lease liability that would be recognized on inception of a lease. As such, the application of this expedient could have a significant impact on an oil and gas entity's balance sheet and key operating measures, including cash costs and earnings before interest, taxes, depreciation, and amortization (EBITDA), and thus should be carefully considered by financial statement preparers before accounting policies are selected.

IFRS 16 requires disclosure of expenses relating to variable lease payments that are not included in the measurement of the lease liability. If a contract contains variable payments that relate to both lease and non-lease components, the same considerations as those discussed above will apply when determining the lease and non-lease components and allocating the variable lease payments.

Discount Rate

A lessee is required to discount the lease payments using the interest rate implicit in the lease if it can be practically determined; however, this may not be readily obtainable. In this case, the lessee uses its incremental borrowing rate, defined as the rate a lessee would have to pay to borrow over a similar term (with similar security) the funds necessary to obtain an asset of a similar value to the leased asset.

Therefore, the lessee's incremental borrowing rate is specific to the:

- lessee (i.e., it is an entity-specific rate, not a market rate)
- term of the arrangement
- amount and currency
- "security" available to the lessor (i.e., collateral available to the lessor)

The discount rate determined can have a significant impact on the initial measurement of the lease liability. Entities can request new borrowing-indicative pricing from their lenders in specified currency and terms. However, estimating the impact of collateralized security

3 The value is based on the stand-alone price or a best estimate of the stand-alone price of the lease component.

is difficult and will require judgment, since not all oil and gas entities use collateral as part of their borrowing strategy.

Weighted Average Lease Term

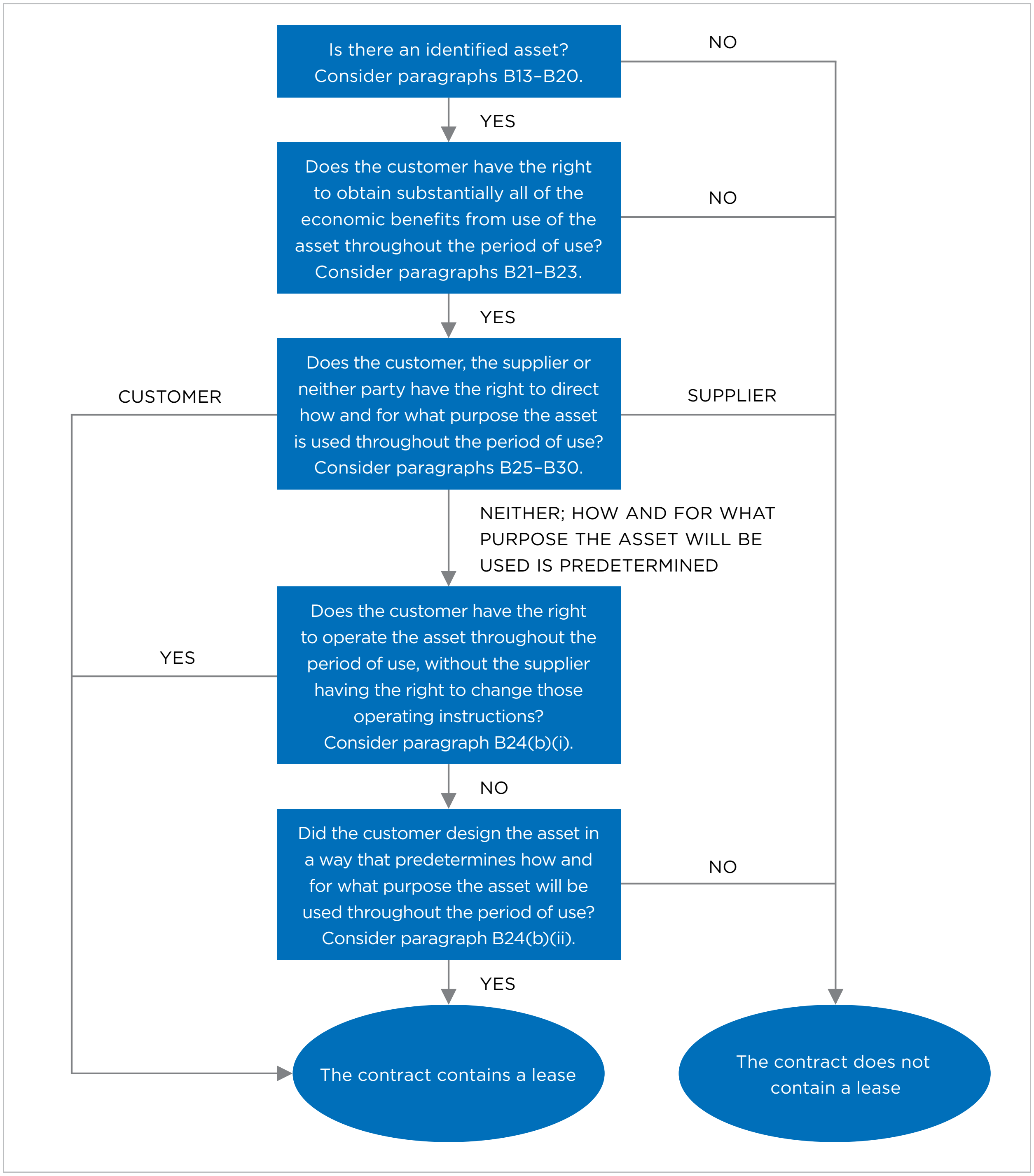
Since risk-free rates exist for various durations, the chosen rate should be matched with the lease term as defined by IFRS 16. For many leases, repayments are spread evenly over the entire lease period, while risk-free rates determined from government bonds or interest-rate yield curves assume a bullet repayment maturity profile. There are varying views concerning how to adjust for this difference in repayment profile; professional judgment and assistance from valuators may be required.

Key Performance Indicators

Oil and gas entities should take into consideration the required disclosures on key performance indicators as a result of adopting IFRS 16. In order to help and educate oil and gas entities in complying with certain securities requirements as a result of IFRS 16, the Office of the Chief Accountant of the Alberta Securities Commission (ASC) prepared a bulletin ***Adoption of IFRS 16: Non-GAAP Financial Measures and Reserves Reporting Considerations***. Oil and gas entities and related stakeholders should consider the matters outlined in the bulletin when disclosing their key performance indicators in relation to the requirements of IFRS 16. This bulletin also contains a discussion of the potential impact of IFRS 16 on developing estimates of costs used in the evaluation of reserves and resources.

Appendix: Flowchart for Identifying a Lease Under IFRS 16

The following flowchart may assist oil and gas entities in making the assessment of whether a contract is (or contains) a lease and has been reproduced from paragraph B31 of IFRS 16.



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

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

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