

IFRS 16 new leases standard

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Practical considerations for Mining and Oil & Gas companies

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What is IFRS 16?

IFRS 16 is a new leasing standard effective for periods beginning on or after **1 January 2019** (subject to EU endorsement).

Early application is permitted, provided the new revenue standard, **IFRS 15 'Revenue from Contracts with Customers'** is applied at the same time as IFRS 16.

IFRS 16 replaces the following standards and interpretations:

- **IAS 17 'Leases'**
- **IFRIC 4 'Determining whether an Arrangement contains a Lease'**
- **SIC-15 'Operating Leases – Incentives'**
- **SIC-27 'Evaluating the Substance of Transactions Involving the Legal Form of a Lease'**

The new standard is a significant change from the existing standard and interpretations as it eliminates the classification of leases as either operating leases or finance leases and, instead, introduces **a single lessee accounting model** which requires a company (the lessee) to recognise all leases on the balance sheet, except for:

- short-term leases containing no purchase options (12 months or less); and
- low value leases (e.g. personal computers or small items of office furniture)

The lessor accounting under IFRS 16 remains largely unchanged i.e. a lessor will continue to classify its leases as operating leases or finance leases, and account for those two types of leases differently.

IFRS 16 specifically excludes leases to explore for or use of minerals, oil, natural gas and similar non-regenerative resources from its scope. However, this exclusion only applies to those surface leases which are directly related to extraction rights and not leases of equipment used for the exploration activities or similar.

What is the main effect of the new standard?

The most significant effect of IFRS 16 will be an increase in lease assets and financial liabilities.

The operating lease expense will effectively be replaced by a combination of depreciation expense arising from the recognition of **a right-of-use asset** and interest expense from the recognition of the obligation to make lease payments.

Measuring liability at amortised costs using the effective interest rate will result in a frontloading of interest expense even when constant periodic lease payments are made.

There will also be an impact on the statement of cash flows as the principal repayments of the lease liability will now be recognised within financing activities as opposed to operating activities where operating leases are currently included.

Accordingly, for companies with material off balance sheet leases, there is likely to be a significant change to a number of key financial metrics such as leverage ratios, operating netbacks, EBITDA and others.

How will Mining and Oil & Gas businesses be affected?

There is a wide range of various arrangements that typically exist within Mining and Oil & Gas industry which may fall within the scope of IFRS 16 such as:

- service contracts including equipment used to deliver a service such as drilling rigs, compressors and tanks;
- shipping, freight and other transportation arrangements, including railway infrastructure and harbour loading services contracts;
- use of gas pipelines and processing facilities;
- refining, tolling and storage arrangements.

There could also be other arrangements not specifically related to extractive activities such as rentals of vehicles, office space and furniture.

Does the contract contain a lease?

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.

Thus, when assessing whether an arrangement contains a lease the two key factors that must be considered are existence of:

- an **identifiable asset**; and
- the **right to control the use** of that asset.

Is there an identifiable asset?

Under IFRS 16, an asset is typically identified by being explicitly or implicitly specified in a contract at the time it is made available for use.

A capacity portion of an asset is still an identified asset if it is physically distinct (e.g. a pipeline that connects a single customer to a larger pipeline or a railway line spur that connects a single customer to a main railway line).

A capacity or other portion of an asset that is not physically distinct (e.g. a capacity portion of a pipeline) is not an identified asset, unless it represents substantially all the capacity such that the customer obtains substantially all the economic benefits from using the asset.

Agreements that convey the right to use an undivided working interest in an identified asset (e.g. a percentage of undivided working interest in a gas processing facility) are not considered physically distinct as they represent partial ownership in the identified asset.

Can the asset be substituted?

Where a supplier has a substantive right of substitution throughout the arrangement, a customer does not have a right to use an identified asset. This can often relate to arrangement involving drilling rigs, compressors, tanks, storage or transportation where the supplier is able to substitute assets, or to use equipment other than the equipment noted in the contract, to perform services.

However, care should be taken when applying this principal as supplier's substitution right might not be substantive if it does not have practical ability to substitute the asset or would not economically benefit. For example:

- alternative assets are not readily available; or
- the asset is highly customised.

Can the entity control the use of the identified asset?

Control is conveyed where the company has both:

- the **right to direct the use** of the identified asset; and

- to obtain **substantially all the economic benefits** from that use.

The **right to direct the use** of an assets is additional criteria in the new leases standard which may involve significant judgements and result in some arrangements not meeting the definition of a lease under the new standard, e.g. a power purchase arrangement which allows the mine to use all of the electricity generated by the plant but not to set the price per unit or direct the output.

In simple terms, it is the right that allows a company to direct how and for what purpose the asset is to be used and operated without the supplier having the right to change those operating instructions.

IFRS 16 gives several examples of the right to direct how and for what purpose the asset is used, such as the right to:

- change the type of output that is produced by the asset;
- determine the quantity of that output; and
- determine when and where the output is produced.

For Mining and Oil & Gas businesses, arrangements that may typically require a judgement when determining whether there is the right to direct the use of an asset are:

- pipeline contracts which allow owners to predetermine the purpose and specifications of the system;
- restrictive specifications around the operations of drilling rigs, gas processing facilities and other equipment;
- mining service contracts which give the company the right to direct the use of the mining equipment but allow the supplier to make certain specific requirements.

For these types of arrangements, it would be necessary to determine whether:

- the company has the right and ability to change the use of the asset, or direct others to operate it in another manner; and
- the supplier's rights are protective in nature and therefore do not give it the right to affect the company's ability to derive substantially all the economic benefits from the use of the asset.

How will new leases be measured?

At the commencement date, a lessee shall measure the right-of-use asset at cost, which comprise:

- the amount of the initial measurement of the lease liability;
- any lease payments made at or before the commencement date, less any lease incentives received;
- any initial direct costs incurred by the lessee; and
- an estimate of costs to be incurred by the lessee in dismantling, removing or restoring the asset.

Subsequently, the lease asset shall be measured at cost less accumulated depreciation and impairment, adjusted for any re-measurements of lease liability.

The lease liability at the commencement date, shall be measured at the present value of the lease payments, discounted using the interest rate implicit in the lease, or the incremental borrowing rate if the implicit interest rate is not available.

Subsequently, the lease obligations shall be measured at amortised costs adjusted for remeasuring of the carrying amount to reflect any reassessment or lease modifications.

What are the transitional arrangements?

On transition to IFRS 16, a lessee has two options of either:

- full retrospective application; or
- modified retrospective application, where a cumulative effect of initially applying the standard is recognised as an adjustment to the opening balance of retained earnings without restating comparative information.

For leases previously classified as operating leases, on transition companies will be required to:

- recognised lease liability measured at the present value of remaining lease payments; and
- recognise the right-of-use asset either at its carrying amount as if the standard has been applied since the commencement date, or at an amount equal to the lease liability adjusted for prepaid/accrued lease payments.

A transitional relief is also available allowing entities to elect not to apply the new standard to existing contracts which were not previously identified as leases under IAS 17 and IFRIC 4.

This relief is only applicable for contracts entered into before the date of the initial application and any subsequent arrangements would need to be assessed in line with the requirements of the new standard.

How to prepare for the transition?

Although IFRS 16 doesn't take effect until January 2019 and is still subject to EU endorsement, to minimise the impact of the new standard companies would benefit from some early planning for the upcoming changes, such as:

- assessing the size and magnitude of the implications on the company's financial position, its performance, covenants compliance as well as various financial measures;
- communicating the key changes to the board and other stakeholders;
- accumulating the relevant information required to determine whether agreements may contain a lease component;
- reviewing internal processes, systems and controls to enable the collection of necessary information, especially if your operations are largely decentralised and geographically dispersed;
- managing the process of negotiating future contracts;
- aggregating the information necessary for disclosures.

How can we help?

This guidance is only a brief summary of the new leases standard and does not cover all aspects of IFRS 16.

At AVEY of London we have specialist knowledge of IFRS and can provide guidance on the changes that will affect your business as well as assist with application and interpretation of the new requirements.

Should you require further information or assistance you can contact AVEY of London on:

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