Leases and joint operations

Reporting Update

5 April 2019, 19RU-002

Highlights

- Agenda decision finalised
- Impact of IFRS 16 on joint arrangements

Lease accounting by operator

Agenda decision finalised

In March 2019 the IFRS Interpretations Committee (IFRS IC) issued its final agenda decision on how the lead operator in a joint operation accounts for lease arrangements. The question has been raised by a number of entities as part of their implementation of IFRS 16 *Leases*.

The decision outlines situations where the joint operation is not structured through a separate vehicle and the lead operator, as a sole signatory, enters into a lease contract with a third party for an item of property, plant and equipment that will be operated jointly as part of the joint operation's activities.

The IFRS IC noted that IFRS 11 *Joint Arrangements* requires the liabilities that a joint operator recognises to include those for which it has primary responsibility. That is, where the lead operator is a sole signatory it would account for the full lease liability on its balance sheet.

In addition, the lead operator would initially account for the entire right-to-use asset. The lead operator would then need to assess contractual arrangements with the other joint operation investors to determine whether a sub-lease is present.

KPMG has updated its guidance on this issue in Insights. Refer to Appendix 1 for three practical examples contained in our guidance.

The IFRS IC agenda decisions is reproduced in Appendix 2.

The IFRS IC has recommended to the IASB that further consideration of accounting for these types of joint operations be conducted as part of the IFRS 11 post-implementation review.

Who is the customer in a joint arrangement?

Impact of IFRS 16 on joint arrangements

IFRS 16 defines a leases as a contract, or part of a contract, that conveys the right to control the use of an identified asset (the underlying asset) for a period of time in exchange for consideration. If a contract contains a lease, then it will generally be on-balance sheet for the lessee.

To determine whether a contract conveys the right to control the use of an identified asset for a period of time, an entity assesses whether, throughout the period of use, the **customer** has a right to:

- obtain substantially all the economic benefits from use of the identified asset, and
- direct the use of the identified asset.

If the customer in the contract is a joint arrangement, then an entity considers whether the joint arrangement has the right to control the use of an identified asset throughout the period of use.

Is it possible for a joint arrangement to be a lessee?

Yes. A joint arrangement – i.e. a joint venture or joint operation – may be a lessee in a lease, provided that the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout its period of use. In many cases, this control is exercised through the joint control of the arrangement.

It would be inappropriate to conclude that a contract does not contain a lease if each of the parties to the joint arrangement:

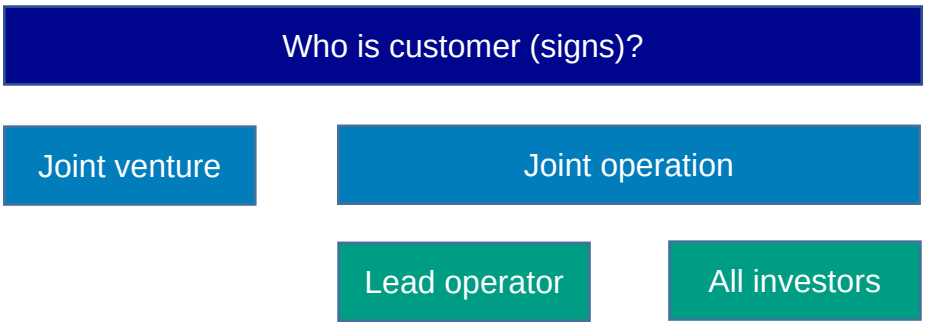
- obtains only a capacity portion that is not physically distinct
- obtains only a portion of the economic benefits from use of the underlying asset, or
- does not unilaterally direct the use of the underlying asset.

Who signs the contract?

Which party/parties signed the contract?

For a joint arrangement to be a lessee, it must first be identified as the customer in the lease contract with the asset supplier. This means that the contract with the asset supplier is:

- entered into by the joint arrangement itself, or
- signed by one or more parties to the joint arrangement on behalf of the joint arrangement.



When the joint arrangement is considered to be the customer in a lease, the accounting for the lease is as follows:

Joint operation

- For a joint operation where the lead operator has signed the lease contract with the asset supplier:
  - The lead operator will account for the full lease liability on its balance sheet. In addition, the lead operator would initially account for the entire right-to-use asset.
  - The lead operator would then need to assess contractual arrangements with the other joint operation investors to determine whether a sub-lease is present.
  - If a sub-lease is present then the other joint operation investors will account for their respective share of the right-of-use asset and their share of the lease liability in their respective financial statements
  - If a sub-lease is not present then the other joint operation investors do not account for the lease on balance sheet.
- For a joint operation where all investors have signed the lease contract with the asset supplier each party to the joint operation accounts for its share of the right-of-use asset and its share of the lease liability in its own financial statements.

Joint venture

- For a joint venture, the right-of-use asset and lease liability are recognised in the financial statements of the joint venture, but not in the financial statements of the partners to the joint venture.

Therefore identifying the customer is critical to determining the accounting for each of the investors in a joint arrangement.

The key consideration for determining if a sub-lease is present is the assessment of who controls the use of the underlying asset:

- If the lead operator solely controls the use of the underlying asset then a sub-lease **would not** be present. The other joint operation investors would account for the reimbursement right under the joint operation contract arrangement between all investors. That is, most likely as an executory contract over time, based on usage.
- If there is collective control over the underlying asset by all joint operation investors then a sub-lease **would** be present. The lead operator would be the lessor in the sub-lease and the other investors would be lessees. As a lessee the other joint operation investors will account for their respective share of the right-of-use asset and their share of the lease liability.

Refer to Appendix 1 for and extract from KPMG's Insights in relation to the above.

Appendix 1 - Updated KPMG examples

Drilling rig contract entered into by the joint operation

Joint Operation J is a separate vehicle with its own legal personality. J enters into a three-year contract with Supplier R, a service provider for the oil and gas industry, for the use of a drilling rig. The drilling rig is explicitly specified in the contract and R has no substitution rights. R is responsible for manning the rig, maintenance and safety. J makes all decisions about when and where to use the rig, as well as which geological targets to test.

In this example, J is the customer because J entered into the contract on its own. Moreover, the contract contains a lease because the drilling rig is an identified asset, J obtains substantially all of the economic benefits from the use of the drilling rig and J directs the right to use it. Therefore, J is the lessee in the lease.

Consequently, each of the parties to J recognises its share of the right-of-use asset and its share of the lease liability.

Drilling rig contract entered into by the operator

Parties X, Y and Z set up Joint Operation K to explore a mineral interest.

X is appointed as the operator of K - i.e. X manages the day-to-day operations of K - and Y and Z are non-operators.

X, and not K, enters into a four-year contract with Supplier R, a service provider for the oil and gas industry, for the use of a drilling rig. The drilling rig is explicitly specified in the contract and R has no substitution rights. R is responsible for manning the rig, maintenance and safety. In accordance with the contract, X makes all decisions about when and where to use the rig, as well as which geological targets to test.

X is involved in a number of projects at various stages of development. X allocates the drilling rig to K for an initial two-year period. During this period, Y and Z reimburse X for their share of the costs. Afterwards, the drilling rig is earmarked for another unrelated mineral interest project in the same geographic region for the remaining two years of the contract.

In this example, X is the customer because X on its own entered into the contract. Moreover, the contract contains a lease because:

- the drilling rig is an identified asset
- X obtains substantially all of the economic benefits from using the drilling rig (by using it to explore its mineral interests and obtaining reimbursements from Y and Z for their share in the costs)
- X directs the right to use the rig (i.e. X can decide when, where and how to use the rig).

Therefore, X is the lessee in a lease with R. Consequently, X has the entire right-of-use asset and lease liability on its balance sheet.

In addition, X will need to determine whether it has entered into a sub-lease of the drilling rig with K, in which X would be the lessor and K the lessee. When determining whether there is such a sub-lease, K needs to be analysed as the customer - i.e. X's share in the joint operation is included.

- If there is such a sub-lease, then X applies lessor accounting for the sub-lease. However, unlike when testing whether there is a sub-lease, lessor accounting for the sub-lease is restricted to Y's and Z's share in K because X cannot record a sub-lease to itself. Consistently, Y and Z account for their respective shares in the sub-lease between X and K.
- If there is no such sub-lease (e.g. because there is no collective control over the rig during the two-year period), then X (as receiver) and Y and Z (as payers) account for reimbursements related to the drilling rig as they would for other cost reimbursements.

Drilling rig contract entered into by all parties to the joint operation

In some cases, all of the parties to a joint operation may sign one contract with a supplier, each in their own name and as a principal. If the joint operators enter into the contract collectively, then it appears that the accounting outcome should be the same as if the joint operation had entered into the contract itself. Consequently, we believe that in this case the joint operation is the customer in the contract.

Appendix 2 - IFRS IC agenda decision

Liabilities in relation to a Joint Operator's Interest in a Joint Operation (IFRS 11 *Joint Arrangements*)

The Committee received a request about the recognition of liabilities by a joint operator in relation to its interest in a joint operation (as defined in IFRS 11). In the fact pattern described in the request, the joint operation is not structured through a separate vehicle. One of the joint operators, as the sole signatory, enters into a lease contract with a third-party lessor for an item of property, plant and equipment that will be operated jointly as part of the joint operation's activities. The joint operator that signed the lease contract (hereafter, the operator) has the right to recover a share of the lease costs from the other joint operators in accordance with the contractual arrangement to the joint operation.

The request asked about the recognition of liabilities by the operator.

In relation to its interest in a joint operation, paragraph 20(b) of IFRS 11 requires a joint operator to recognise 'its liabilities, including its share of any liabilities incurred jointly'. Accordingly, a joint operator identifies and recognises both (a) liabilities it incurs in relation to its interest in the joint operation; and (b) its share of any liabilities incurred jointly with other parties to the joint arrangement.

Identifying the liabilities that a joint operator incurs and those incurred jointly requires an assessment of the terms and conditions in all contractual agreements that relate to the joint operation, including consideration of the laws pertaining to those agreements.

The Committee observed that the liabilities a joint operator recognises include those for which it has primary responsibility.

The Committee highlighted the importance of disclosing information about joint operations that is sufficient for a user of financial statements to understand the activities of the joint operation and a joint operator's interest in that operation. The Committee noted that, applying paragraph 20(a) of IFRS 12 *Disclosure of Interests in Other Entities*, a joint operator is required to disclose information that enables users of its financial statements to evaluate the nature, extent and financial effects of its interests in a joint operation, including the nature and effects of its contractual relationship with the other investors with joint control of that joint operation.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for the operator to identify and recognise its liabilities in relation to its interest in a joint operation. Consequently, the Committee decided not to add this matter to its standard-setting agenda.