

## Oil & Gas Spotlight

# FASB and IASB Re-Lease Proposed Standard

### In This Issue:

- Overview of the Proposed Standard
- Implications for Oil and Gas Companies
- Operational Challenges
- Thinking Ahead



## The Bottom Line

The proposed lease guidance could significantly affect oil and gas companies, since they would need to reassess their contracts, including those related to onshore and offshore drilling, transportation and storage, and joint operations.

- On May 16, 2013, the FASB and IASB jointly issued a revised exposure draft (ED) on lease accounting. Under the proposal, lessees would record most leases that are currently treated as operating leases on the balance sheet by recognizing a right-of-use (ROU) asset and a corresponding lease liability.
- The proposed lease guidance could significantly affect oil and gas companies, since they would need to reassess their contracts, including those related to onshore and offshore drilling, transportation and storage, and joint operations. For companies with a large number of contracts in their portfolio, doing so could take considerable time and effort.
- The ED defines a lease as a “contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.” To determine whether a given contract meets this definition, companies would need to assess whether the contract is based on an identified asset and whether the lessee obtains the right to control the use of the asset for a particular period.
- Under the ED, a lease is classified as one of two types on the basis of whether the underlying asset is considered “property” (defined as “[I]and or a building, or part of a building, or both”) and the terms of the lease. Although lessees would record most leases on their balance sheet, the ED’s effect on the income statement would depend on the lease classification.
- Comments on the ED are due by September 13, 2013.

# Beyond the Bottom Line

This *Oil & Gas Spotlight* provides insight into select aspects of the ED that are relevant to lessees and lessors in the oil and gas industry. For a comprehensive overview of the ED, including illustrative examples, see Deloitte's May 17, 2013, [Heads Up](#).

## Overview of the Proposed Standard

The ED would significantly affect entities in the oil and gas industry because of their extensive use of fixed assets under contracts that may qualify as leases under the proposed guidance. Lease agreements for such assets are frequently customized and include other services and components that are important to the contract. While the accounting for operating leases is often similar to that for service contracts under existing guidance, this would no longer be the case under the proposal. Accordingly, entities would need to reevaluate their contracts to determine the appropriate accounting.

### Scope

The scope of the ED would be similar to that of existing lease accounting requirements and would include all assets and not just property, plant, and equipment. ROU assets in a sublease would be within the ED's scope, as would assets that are often treated as inventory (e.g., spare parts and supplies). However, entities would not be required to account for leases of intangible assets in accordance with the proposed guidance. In addition, the scope of the ED, like that of current guidance, would exclude leases related to the exploration for, or use of, nonregenerative resources, such as oil and natural gas.

### Identifying a Lease

The ED defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration." When determining whether a contract contains a lease under the ED, entities should assess whether (1) the contract is based on an identified asset and (2) the lessee obtains the right to control the use of the asset for a particular period.

The ED's concept of identifying the asset is consistent with that in current GAAP. Under the proposal, a leased asset must be specifically identifiable either explicitly (e.g., by a specific serial number) or implicitly (e.g., the asset is the only one available to meet the requirements of the lease contract). The evaluation should take into account any substantive rights of the lessor to substitute the underlying asset. Substitution rights would be considered substantive if the lessor can substitute the leased asset without the customer's consent and no barriers would prevent substitution (e.g., high costs or the unavailability of alternative assets). The ED also proposes that a specified asset could be a physically distinct portion of a larger asset (e.g., one floor of a building). However, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of a pipeline) would generally not be a specified asset under the proposal.

The ED would align the assessment of whether a contract gives the lessee the right to control the specified asset with the concept of control developed as part of the project on revenue recognition. Accordingly, a contract would convey the right to control the use of an identified asset if the customer has the ability to direct, and derive benefits from, the use of that asset. The ability to direct the use of the specified asset includes the determination of when and how the asset is used. Benefits of use would include direct economic gain stemming from use of the asset. See the [Implications for Oil and Gas Companies](#) section below for additional details.

The scope of the ED would be similar to that of existing lease accounting requirements and would include all assets and not just property, plant, and equipment.

The ED includes guidance on evaluating a contract containing lease and nonlease components (e.g., equipment and maintenance), which must be accounted for separately. For leases including multiple underlying assets, a company would need to determine whether (1) “[t]he lessee can benefit from use of the asset either on its own or together with other resources that are readily available to the lessee” and (2) “[t]he underlying asset is neither dependent on nor highly interrelated with the other underlying assets in the contract” in assessing whether each asset should be treated as a separate lease component.

## Lessee Accounting

The ED’s proposed accounting model for lessees is based on an ROU approach under which lessees would generally recognize (1) an asset for the right to use the underlying asset (ROU asset) and (2) a liability to make lease payments. Both would initially be measured as the present value of the future lease payments. Under the ED, lease arrangements would be classified as one of two types: a financing lease (Type A lease) or a straight-line lease (Type B lease). The subsequent accounting would depend on this classification.

To determine the lease classification, a lessee would consider the nature of the asset being leased as well as the terms and conditions of the lease, as explained in the following table:

Lease of an Asset Other Than Property	Lease of Property
<p>A lessee will classify a lease of an asset other than property as Type A (financing approach) unless:*</p> <ol style="list-style-type: none"> <li>1. “[t]he lease term is for an insignificant part of the <b>total economic life</b> of the underlying asset” (emphasis added); or</li> <li>2. “[t]he present value of the lease payments is insignificant relative to the fair value of the underlying asset.”</li> </ol> <p>* If a lessee has a significant economic incentive to exercise an option to purchase the underlying asset, the lease would be classified as Type A regardless of whether it meets the exceptions.</p>	<p>A lessee will classify a lease of property as Type B (straight-line approach) unless:</p> <ol style="list-style-type: none"> <li>1. “[t]he lease term is for the major part of the <b>remaining economic life</b> of the underlying asset” (emphasis added); or</li> <li>2. “[t]he present value of the lease payments accounts for substantially all of the fair value of the underlying asset”; or</li> <li>3. “[the] lessee has a significant economic incentive to exercise an option to purchase the underlying asset.”</li> </ol>

For leases accounted for under the financing approach, the ROU asset would be amortized in the same manner as other nonfinancial assets. For leases accounted for under the straight-line approach, the ROU asset would be amortized in a way that ensures a straight-line total lease expense (including the interest expense related to the lease liability). Such straight-line lease expense would be presented as a rental expense rather than depreciation and interest costs.

It is expected that many current operating leases for properties would qualify for the straight-line lease expense approach under the ED (although companies would now recognize the lease obligation and ROU asset). However, leases that begin within the latter portion of the total estimated life of the property would more likely be accounted for under the financing approach because the ED, unlike current U.S. GAAP, does not propose exemptions for evaluating the classification of a lease whose term begins during the last 25 percent of the asset’s total economic life.

The proposed lease guidance would require a lessee to record *all leases* (other than those deemed short-term) on the balance sheet. This requirement could significantly affect the balance sheet of an oil and gas company that has a large number of leases in its portfolio. Further, the two-model approach would have a far greater impact on leases of assets other than property. It is expected that only shorter-term leases of assets other than property would qualify for the straight-line approach.

The ED’s proposed accounting model for lessees is based on an ROU approach under which lessees would generally recognize (1) an asset for the right to use the underlying asset (ROU asset) and (2) a liability to make lease payments.

## Lessor Accounting

Under the proposal, a lessor would classify a lease as a receivable-and-residual lease (Type A lease) or an operating lease (Type B lease) on the basis of the nature of the asset being leased as well as the terms and conditions of the lease, as explained in the following table:

Lease of an Asset Other Than Property	Lease of Property
<p>A lessor will classify the lease of an asset other than property as a Type A lease (receivable-and-residual approach) unless:*</p> <ol style="list-style-type: none"> <li>1. “[t]he lease term is for an insignificant part of the <b>total economic life</b> of the underlying asset” (emphasis added); or</li> <li>2. “[t]he present value of the lease payments is insignificant relative to the fair value of the underlying asset.”</li> </ol> <p>* If a lessee has a significant economic incentive to exercise an option to purchase the underlying asset, the lease would be classified as Type A regardless of whether it meets the exceptions.</p>	<p>A lessor will classify the lease of property as a Type B lease (operating-lease approach) unless:</p> <ol style="list-style-type: none"> <li>1. “[t]he lease term is for the major part of the <b>remaining economic life</b> of the underlying asset” (emphasis added); or</li> <li>2. “[t]he present value of the lease payments accounts for substantially all of the fair value of the underlying asset”; or</li> <li>3. “[the] lessee has a significant economic incentive to exercise an option to purchase the underlying asset.”</li> </ol>

Under the proposal, a lessor would classify a lease as a receivable-and-residual lease (Type A lease) or an operating lease (Type B lease) on the basis of the nature of the asset being leased as well as the terms and conditions of the lease.

If the lessor concludes that it should account for the lease by using the receivable-and-residual approach, it would derecognize the carrying amount of the underlying asset and recognize:

- A lease receivable representing the right to receive lease payments throughout the lease term. This is measured as the present value of the lease payments discounted at the rate the lessor charges the lessee.
- A residual asset representing the lessor’s claim to the residual value of the leased asset at the end of the lease term. This is measured as the present value of the residual asset less the deferred profit (if any). In subsequent periods, the accretion of the residual asset would be recognized as interest income.
- A gain or loss on the effective “sale” of a portion of the underlying asset. This is measured as the difference between the lease receivable and an allocated amount of the previous carrying value of the underlying asset.

The receivable-and-residual model is generally consistent with the sales-type lease accounting approach that lessors apply under current U.S. GAAP; however, the portion of the profit related to the residual asset would be deferred. Accordingly, a lessor would recognize up-front profit or loss on the “sale” and then recognize interest income on the receivable (as well as the residual asset) over the lease term. Lease-related income would be front-loaded as a result of recognizing both the “sale” at inception and higher interest income in the earlier portion of the lease.

The ED requires lessors to present the “sale” in their income statement by using a method that is consistent with their business model. That is, the gain or loss might be recognized on either a gross or a net basis.

If a lessor determines that the lease should be accounted for under the operating-lease approach, it would account for the lease contract by using an approach similar to the operating-lease approach under current U.S. GAAP. That is, at lease commencement, the lessor would continue to recognize the leased asset in its statement of financial position and, in subsequent periods, would recognize (1) lease income by using a straight-line approach or another systematic basis and (2) depreciation expense for the leased asset by using an appropriate method of depreciation.

The ED could significantly affect when a lessor recognizes lease income. Because leases of assets other than property would only be expected to qualify for the operating-lease approach if the lease is shorter-term, current operating leases for such assets that would be accounted for under the receivable-and-residual approach under the proposal would be significantly affected. Specifically, recognition of income on a straight-line basis over the lease term would be replaced with recognition of profit (if any), followed by recognition of a decreasing amount of interest income in each subsequent period.

## Implications for Oil and Gas Companies

### Drilling Contracts

Given the breadth of contract structures used in oil and gas exploration and production, oil and gas companies may need to increase their scrutiny of both onshore and offshore drilling contracts to determine whether such contracts are (or contain) leases under the proposed standard:

- *Control*— The extent of a well operator’s control over a drilling rig will differ significantly on the basis of the structure of the drilling contract (e.g., whether it is a day-work, turnkey, or footage contract). While the well operator may have greater control over the rig in a day-work contract, the independent contractor (the rig owner) typically retains more control in a turnkey contract. In a footage contract, the well operator’s level of control will generally lie somewhere between the level a day-work contract provides for and that which a turnkey contract allows. Entities will be required to exercise judgment in evaluating the facts and circumstances of a contract to determine the extent of control an operator has.
- *Identifiable assets*— Because of the nature of projects undertaken and the various logistical and technical complexities involved, specific rigs are often explicitly or implicitly identified in the terms of a drilling contract. Drilling contracts may also involve capital upgrade requirements that make it necessary for an independent contractor to custom-fit a specific rig to meet an operator’s unique drilling program needs.

The terms and conditions of drilling contracts are often complex and specifically negotiated, making it challenging for entities to determine the appropriate accounting under the proposed guidance. The determination of whether a well operator controls an identified rig in a drilling contract would dictate whether the arrangement is accounted for as a lease or treated as a service.

### Transportation and Storage Contracts

Existing contract structures to transport or store oil and gas products would need to be evaluated in light of the proposed guidance’s definition of a lease. Examples of underlying assets that may be used to store or transport those products include the following:

- *Pipelines*— Current guidance does not preclude a percentage of a pipeline’s transport or storage capacity from being subject to a lease. Under the proposed lease standard, however, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of a pipeline) would generally not be a specified asset. Therefore, a pipeline contract that does not provide for the use of substantially all of the capacity would be outside the scope of the proposed lease standard. Because pipeline contracts can be structured differently (e.g., on the basis of a percentage of benefits), companies would have to review them to determine the appropriate accounting.

The terms and conditions of drilling contracts are often complex and specifically negotiated, making it challenging for entities to determine the appropriate accounting under the proposed guidance.

In a manner consistent with current lease accounting, oil and gas companies would need to consider the interaction of certain lease contract terms with other U.S. GAAP accounting requirements.

- *Vessels* — The transportation of liquid and gas products is addressed in many types of contracts, such as bareboat, time, and voyage charters. Such shipping contracts can take various forms, and their terms can differ significantly. For instance, bareboat charters may involve a specific vessel or a physically distinct portion of a vessel; time charters, on the other hand, may allow for substantive substitution of the vessel. In addition, the ability of the charterer-in to direct the use of a vessel may vary in a time or voyage charter, in which the vessel is operated by the charterer-out’s crew. Because contracts for the right to use a vessel could be considered to constitute or contain leases under the proposed guidance, a company would need to evaluate such contracts to determine the appropriate accounting.
- *Railcars* — The use of railcars to transport or store oil and gas products (e.g., cooled railway tankers to transport liquefied natural gas) will remain important as infrastructure in the United States, Canada, and other countries continues to develop. Contracts involving railcars may be considered leases under the proposed guidance but may also constitute service agreements. This determination would depend on the extent of the freight supplier’s (1) involvement in directing the use of the railcars or (2) ability to substitute identified railcars under the contract. The appropriate accounting for such contracts will be heavily based on their specific terms. Examples 1A through 1C in ASC 842-10-55-7 (proposed by the ED) illustrate how a company would determine whether a contract for railcars contains a lease.

### Joint Operating Agreements

Operators of oil and gas properties may execute agreements, such as the contracts discussed above, that could be considered leases under the proposed guidance. Operators are legally obligated to counterparties named in the agreement, whereas nonoperators are not typically listed as additional parties to the agreement and do not exhibit control. For leases that are accounted for under the financing approach, lessee operators of joint-interest property will report front-loaded expenses, as discussed above. However, joint operating agreements will usually stipulate that nonoperators are billed net, on an as-incurred basis, for their pro rata portion of all costs and expenses; such an arrangement will result in a recognition mismatch for the operator of the oil and gas property. Exploration and production companies may want to consider the potential impact of such a mismatch on their financial statements as they elect to enter into agreements as operators or nonoperators.

In a manner consistent with current lease accounting, oil and gas companies would need to consider the interaction of certain lease contract terms with other U.S. GAAP accounting requirements. For example, oil and gas companies would have to determine whether an obligation to decommission a leased asset should be considered a “lease payment” within the context of lease guidance or an asset retirement obligation under other U.S. GAAP. This determination could result in significantly different initial and subsequent measurement considerations for the obligation.

### Operational Challenges

#### Information Technology Systems, Applications, and Processes

In addition to the accounting and financial reporting implications, companies may face operational challenges related to their IT systems, applications, and processes:

- *Changes to systems, processes, and controls* — Companies will most likely need to make several changes to systems, processes, and controls to store key data, perform calculations, and process accounting entries in a controlled and secure environment on an ongoing basis. To allow for potentially lengthy lead times, companies would need to implement these changes long before adopting the standard.

Companies in the oil and gas industry are encouraged to continue their active role in the standard-setting process. Comments on the ED are due by September 13, 2013.

- *Data requirements* — Some companies have numerous lease agreements encompassing multiple decentralized locations in different business and operating units. It may be time-consuming for such companies to gather data, particularly when the information is located in multiple systems or maintained manually.
- *Data repository considerations* — Companies often have limited systems capability to track and record the additional lease information they need to apply the new guidance. In addition, because many lease agreements involve decentralized locations, companies may find a centralized information repository helpful when developing a complete inventory of leases.
- *IT systems* — Companies must consider whether to develop functionality within an existing enterprise resource planning system or whether to implement new modules to comply with the proposed lease standard. In addition, companies may need to establish new processes for identifying and assigning value to embedded service and lease components in service arrangements that will now contain a lease under the proposed standard. Because systems initiatives entail long lead times, interim solutions may also be required.

### Implementation Considerations

Oil and gas companies will also encounter numerous challenges in implementing the ED, including those related to:

- *Increased judgment* — Given the replacement of bright-line rules with a principles-based approach, companies will often have to use judgment in applying the ED (e.g., when determining whether an arrangement is a lease, choosing the appropriate lease classification, and measuring lease payments and lease term). These judgments should be consistent throughout the organization.
- *Periodic evaluation* — Companies would have to revisit their lease portfolios periodically, on an individual-lease basis, to reevaluate whether they need to change any assumption (e.g., the lease term) on the basis of new facts or circumstances. The process may be labor-intensive for companies that have entered into a large number of lease arrangements.
- *Impact on the financial statements* — For leases accounted for under the finance approach, the proposed lease standard would result in lessees' recording higher lease expenses at the beginning of the lease that diminish toward the end of the lease period. In addition, the proposed lease guidance could have statutory reporting implications for subsidiaries because it would significantly affect the accounting for intercompany leasing activities.
- *Taxes* — Tax departments would need to evaluate how the accounting changes will affect the overall tax analysis, including cash taxes paid (i.e., financial statement changes may affect transfer pricing, state apportionment, or non-U.S. taxes) and changes in deferred taxes related to book/tax differences in the accounting for leases.
- *Contractual terms tied to financial metrics* — The proposed accounting changes could affect many key financial statement measures tied to the balance sheet (e.g., leverage ratios) and income statement (e.g., EBITDA). Companies should proactively assess the impact of the accounting changes on contracts with terms linked to financial metrics, such as debt arrangements, earn-outs, and compensation arrangements.

### Thinking Ahead

The boards have requested feedback on many of the core elements of the ED. Companies in the oil and gas industry are encouraged to continue their active role in the standard-setting process. Comments on the ED are due by September 13, 2013.

## Contacts

If you have questions about this publication, please contact the following Deloitte industry professionals:

### Paul Horak

U.S. AERS Oil & Gas Audit Leader  
Deloitte & Touche LLP  
+1 713 982 2535  
[phorak@deloitte.com](mailto:phorak@deloitte.com)

### Phillip Hilsher

Industry Professional Practice  
Director, Oil & Gas  
Deloitte & Touche LLP  
+1 713 982 4644  
[philsher@deloitte.com](mailto:philsher@deloitte.com)

### Nick Difazio

Financial Accounting, Valuation, &  
Securitization  
Deloitte & Touche LLP  
+1 313 396 3208  
[ndifazio@deloitte.com](mailto:ndifazio@deloitte.com)

### John Vickers

Financial Accounting, Valuation, &  
Securitization  
Deloitte & Touche LLP  
+1 713 982 2329  
[jovickers@deloitte.com](mailto:jovickers@deloitte.com)

### Jodie Beining

Director  
Deloitte Tax LLP  
+1 414 347 7902  
[jbeining@deloitte.com](mailto:jbeining@deloitte.com)

### John A. Gimpert

Partner  
Deloitte & Touche LLP  
+1 312 486 2591  
[jgimpert@deloitte.com](mailto:jgimpert@deloitte.com)

## Subscriptions

Don't miss an issue! Register to receive [Spotlight](#) and other Deloitte publications by going to [www.deloitte.com/us/subscriptions](http://www.deloitte.com/us/subscriptions), choosing the Industry Interests category, and checking the boxes next to your particular interests. Publications pertaining to your selected industry (or industries), along with any other Deloitte publications or webcast invitations you choose, will be sent to you by e-mail.

## Dbriefs for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts in the "Financial Executives" series on the following topics:

- Business strategy & tax.
- Driving enterprise value.
- Financial reporting.
- Financial reporting for taxes.
- Governance and risk.
- Sustainability.
- Technology.
- Transactions & business events.

*Dbriefs* also provides a convenient and flexible way to earn CPE credit — right at your desk. [Join Dbriefs](#) to receive notifications about future webcasts at [www.deloitte.com/us/dbriefs](http://www.deloitte.com/us/dbriefs).

Registration is available for this upcoming *Dbriefs* webcast. Use the link below to register:

- [Regulatory Compliance in the Face of Financial Crime, Money Laundering, and Cyber Threats](#) (July 23, 2 p.m. (EDT)).

## Technical Library: The Deloitte Accounting Research Tool

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, the EITF, the AICPA, the PCAOB, the IASB, and the SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Technical Library subscribers also receive *Technically Speaking*, the weekly publication that highlights recent additions to the library.

In addition, Technical Library subscribers have access to Deloitte Accounting Journal entries, which briefly summarize the newest developments in accounting standard setting.

For more information, including subscription details and an online demonstration, visit [www.deloitte.com/us/techlibrary](http://www.deloitte.com/us/techlibrary).

The Spotlight series is prepared by the National Office Accounting Standards and Communications Group of Deloitte. New issues in the series are released as developments warrant. This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.