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CERTIFIED PUBLIC ACCOUNTANTS

The Effect of ASC 842 on Oil and Gas Production Entities

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Introduction

The Financial Accounting Standards Board (FASB) has issued new accounting standards for leases and created a new section in the Accounting Standards Codification (ASC) – 842 Leases. This new accounting guidance for leases is already in effect for public entities. For private companies, it does not go into effect until annual financial statements beginning after December 15, 2021, and interim financial statements beginning after December 15, 2022.

The scope of ASC 842 excludes leases to explore for or use oil and natural gas, including the right to use land in which those natural resources are contained (that is unless those rights of use include more than the right to explore for natural resources), but not the equipment used to explore for the natural resources.

For oil and gas entities, identifying leases will require careful and thorough analysis. There are various agreements that typically exist within the oil and gas industry which may fall within the scope of the new lease standard, such as:

- Drilling contracts
- Compressor rental
- Tank rental
- Transportation agreements, including rail and midstream infrastructure
- Refining arrangements

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

Given the many accounting changes involved, businesses must begin preparing now to comply with the new standards.

What Defines a Lease in ASC 842?

A contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment (an identified asset) for a period of time in exchange for consideration.

A period of time may be described in terms of the amount of use of an identified asset. For example, the number of production units that an item of equipment will be used to produce.

Identified Asset

An asset typically is identified by being explicitly specified in a contract. However, an asset also can be identified by being implicitly specified at the time that the asset is made available for use by the customer.

Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if **both** of the following conditions exist:

a) The supplier has the practical ability to substitute alternative assets throughout the period of use. For example, the customer cannot prevent the supplier from substituting an asset, and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time.
b) The supplier would benefit economically from the exercise of its right to substitute the asset (that is, the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

A capacity portion of an asset is an identified asset if it is physically distinct. For example, a floor of a building or a segment of a pipeline that connects a single customer to the larger pipeline. A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

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:

a) The right to obtain substantially all of the economic benefits from use of the asset.
b) The right to direct the use of the identified asset.

Lease Term

The noncancellable period for which a lessee has the right to use an underlying asset, together with **all** of the following:

a) Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option.
b) Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.
c) Periods covered by an option to extend (or not terminate) the lease in which the exercise of the option is controlled by the lessor.

Separating Components of a Contract

After determining that a contract contains a lease, an entity shall identify the separate lease components within the contract. An entity shall consider the right to use an underlying asset to be a separate lease component (that is, separate from any other lease components of the contract) if **both** of the following criteria are met:

a) The lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services sold or leased separately (by the lessor or other suppliers) or resources that the lessee already has obtained (from the lessor or other transactions or events).
b) The right of use is neither highly dependent on nor highly interrelated with the other right(s) to use underlying assets in the contract. A lessee's right to use an underlying asset is highly dependent on or highly interrelated with another right to use an underlying asset if each right of use significantly affects the other.

Practical Expedient to Not Separate Non-lease and Associated Lease Components — Lessees

ASC 842 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 its associated non-lease components as a single lease component.

Lease and Non-lease Components

A contract may contain one or more leased items, as well as non-lease goods and services. The lease accounting model need not apply to non-lease contract components (items or activities that transfer a good or service to the lessee). The land is a separate lease component unless the accounting effect of treating it as such would be insignificant (e.g., the new amount recognized for the land lease component would be negligible, or separating the land lease component would not affect the lease classification of any individual lease component).

Previous leasing guidance allocated property taxes and insurance separately from minimum lease payments. Under ASC 842, however, reimbursements to the owner for property tax and insurance are not separate goods or services. Therefore, they are not considered components, and any associated lessee fixed or variable payments should be treated as part of overall contract consideration, allocated between the lease and non-lease components. In contrast, maintenance services involve delivering a separate service and are therefore considered a non-lease component if provided by the lessor to the lessee.

Lease Classification

At lease commencement, a lessee classifies a lease as a finance lease and a lessor classifies a lease as a sales-type lease if the lease meets **any** one of the following criteria:

a) The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
b) The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise. (It no longer is just a bargain purchase option that meets this criteria.)
c) The lease term is for a major part of the remaining economic life of the underlying asset. This criterion is not applicable for leases that

commence at or near the end of the underlying asset's economic life.

d) The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.
e) The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

When **none** of the criteria are met above:

a) A lessee classifies a lease as an operating lease.
b) A lessor shall classify the lease as an operating lease unless both of the following criteria are met, in which case the lessor shall classify the lease as a direct financing lease:

    1) The present value of the sum of lease payments and any residual value guaranteed by the lessee and any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.
    2) It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

Lessee Accounting

At the commencement date of a lease, a lessee recognizes an asset that represents a lessee's right to use an underlying asset for the lease term (i.e., the right-of-use asset) and a liability representing a lessee's obligation to make the lease payments arising from a lease, measured on a discounted basis (i.e., the lease liability).

The initial recognition of the right-of-use asset and the lease liability is the same for operating leases and finance leases, as is the subsequent measurement of the lease liability. However, the subsequent measurement of the right-of-use asset for operating leases and finance leases differs under ASC 842. For operating leases, lessees are required to recognize a single lease cost that is recognized on a straight-line basis.

For finance leases, lessees are required to separately recognize the interest expense on the lease liability and the amortization expense on the right-of-use asset. This often results in a front-loaded expense recognition pattern due to higher interest expense at the beginning of the lease compared to the end of the lease.

Short-term Leases Recognition and Measurement Exemption

Lessees can make an accounting policy election (by class of underlying asset to which the right of use relates) to apply accounting to recognize the lease payments in profit or loss on a straight-line basis over the lease term to leases that meet ASC 842's definition of a short-term lease (i.e., the short-term lease exemption). A short-term lease is defined as a lease that at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. The short-term lease election can only be made at the commencement date.

A lessee that makes this accounting policy election does not recognize a lease liability or right-of-use asset on its balance sheet. Instead, the lessee recognizes lease payments as an expense on a straight-line basis over the lease term and variable lease payments that do not depend on an index or rate as expense in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable. Any recognized variable lease expense is reversed if it is probable that the specified target will no longer be met.

Lease Modifications

ASC 842 defines a lease modification as a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease. For example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term. Additionally, a modification may occur when entities agree to revise a storage or transportation contract.

Lessees and lessors account for a lease modification as a separate contract (i.e., separate from the original contract) when **both** of the following conditions are present:

a) The modification grants the lessee an additional right of use not included in the original lease. For example, the right to use an additional asset.
b) The lease payments increase commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract. For example, the standalone price for the

lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building because a lessor did not need to incur costs that it would have incurred for a new lessee.

If a lease is modified and that modification is not accounted for as a separate contract as discussed above, the entity shall reassess the classification of the lease as of the effective date of the modification.

Lease of a Related Party

Leases between related parties should be classified in accordance with the lease classification criteria applicable to all other leases based on the legally enforceable terms and conditions of the lease. In the separate financial statements of the related parties, the classification and accounting for the leases should be the same as for leases between unrelated parties.

Joint Operating Agreements

In the oil and gas industry, mineral interests are owned by various parties through a legal, undivided interest held by each party. Joint operating agreements (JOA) are commonly used to conduct business between these various parties that share the mineral interest ownership. In the JOA, one of the parties is designated as an operator of the oil and gas property and agrees with the other parties (nonoperators) to manage the property's day-to-day operations, including the drilling and production phases.

The operator is the party that enters into various contracts, including drilling contracts, to develop and manage the mineral interest. These contracts may contain leases. The contracts should be evaluated to determine which party(ies) are counterparties with the supplier. If the operator is determined to be the counterparty to the lease, the JOA should be evaluated to determine if it creates a sublease between the operator and nonoperators. Unless there is a physically distinct asset under the lease with respect to each nonoperator, a sublease is usually not applicable.

In most cases, the operator is the named party to the drilling and supply contracts with a supplier. Suppose the operator determines that it controls the use of the identified asset. In that case, the operator will recognize 100% of the right-of-use asset and lease liability to be recognized in accordance with ASC 842.

Rights of Way and Land Easements

Land easements are common for the operators of gathering lines and pipelines. A land easement may be perpetual or term-based, provide for exclusive or nonexclusive land use, and may be prepaid or paid over a defined term.

Perpetual easements are outside the scope of ASC 842, as the definition of a lease requires the contract to be for a period of time. Therefore, entities must carefully evaluate easement contracts to determine whether the contract is perpetual or for a period of time.

Practical Expedient to Not Reconsider its Accounting for Existing Land Easements

The FASB has issued a practical expedient that allows entities not to reconsider their accounting for existing land easements that are not accounted for under the old lease accounting guidance. However, all new or modified land easements will need to be evaluated to determine if they fall with the scope of ASC 842.

Next Steps

Lease accounting for the energy industry includes a multitude of changes under the new standards. Identifying leases under the new rules will require careful analysis and time.

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