August 2, 2018

# ASU 2016-02: How the Lease Standard Will Impact Drilling Companies

AUDIT, ENERGY & RESOURCES, LEASES
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On February 25, 2016, the Financial Accounting Standards board ("FASB") issued ASU 2016-02 on leases, which is effective for calendar periods beginning January 1, 2019 for public business entities and January 1, 2020 for all other entities and represents a significant change to lease accounting. As a result, oil and gas companies will face significant implementation challenges during the transition period. The scope of the standard is limited to leases of property, plant and equipment ("PP&E") and excludes leases of intangible assets; leases to explore for or use minerals, oil, natural gas and similar nonregenerative resources; leases of biological assets; leases of inventory; and leases of assets under construction.

The new standard defines a lease as "a contract, or part of a contract, that conveys the right to control the use of identified PP&E (an identified asset) for a period of time in exchange for consideration." Control is considered to exist if the customer has both of the following characteristics: 1) the "right to obtain substantially all of the economic benefits from the use of an asset," and 2) the "right to direct the use of the asset."

ASU 2016-02 is consistent with existing accounting pronouncements in that the leased asset must be identifiable either explicitly or implicitly. The evaluation of whether there is an identified asset, however, depends on whether a supplier has a substantive substitution right through the period of use that differs from current guidance. Substitution rights are considered substantive if the supplier has the ability to substitute alternative assets through the period of use and the supplier would benefit economically from the substitution. The leasing entity should consider facts and circumstances at the inception of the contract, which will require significant judgment when determining whether a substitution right is substantive.

The new standard represents a significant change from current lease guidance with regard to a customer's right to control the use of the identified asset. Under current U.S. GAAP, an entity's taking of substantially all outputs of an identified asset was considered indicative of the customer's right to control the use of the asset if the pricing per unit in the arrangement was neither fixed nor market at the time of delivery. The new standard aligns the assessment of whether a contract gives the customer the right to control the use of the specified asset with the concept of control developed as part of the FASB's new revenue recognition standard. Therefore, a contract evaluated under the new standard is deemed to convey the right to control the use of an identified asset if the customer has both the right to direct and obtain substantially all economic benefits from the use of the asset. The right to direct the use of the specified asset will take into account whether the customer has the right to determine (or predetermine through a contract) how and for what purpose the asset is used. Economic benefits from the use of the specified assets would include those the customer can realize in a transaction with a third party.

Oil and gas entities need to increase scrutiny of their contracts to determine whether such contracts are leases under the new standard. The terms of drilling contracts are often complex and differ from contract to contract, which can cause challenges to determine the appropriate accounting under the new guidance. The determination of whether a well operator controls an identified rig in a drilling contract will dictate whether the arrangement is accounted for as a lease on the balance sheet or is treated as an off-balance sheet service arrangement.

Fulfillment of the contract depends on the use of an identified asset. Due to the nature of the projects and the complexities involved, specific rigs are often explicitly or implicitly identified in the terms of a drilling contract, which may also involve capital upgrade requirements that make it necessary for an independent contractor to custom-fit a rig to meet the operator’s needs. The fulfillment of a drilling contract will often depend on the use of a specified drilling rig that would meet the definition of an identified asset under the new standard.

A well operator has the right to direct the use of a specified drilling rig if it can determine how and for what purpose the asset is used. Additionally, the extent to which an operator determines how and for what purpose the specific rig is used will depend on whether the drilling contract grants the operator decision-making rights over the asset. An operator should identify the rights that most impact how and for what purpose the rig is used throughout the period of use and determine who controls those rights. If the decisions related to how and for what purpose the rig is used are predetermined, the assessment should focus on whether the operator controls the drilling program or designed the aspects of the rig that are most relevant to how and for what purpose it is used. Meeting either of the above criteria would be deemed to convey the right to direct the use of the identified asset to the operator.

The decision-making rights that most affect the economic benefits to be derived from a drilling rig are likely to differ depending on the type of drilling contract (turnkey, footage, day rate). In all scenarios, oil and gas entities will need to evaluate on the basis of the specific facts and circumstances whether they have the right to determine how and for what purpose a specified drilling rig is used and, thus, the right to direct the use of the asset. Oil and gas entities will need to use judgment when performing the evaluations.

Schneider Downs professionals have the resources and tools to assist in developing and executing an action plan for implementing the new standard. Our services include help with accounting interpretations, process revisions, software implementations and tax analysis. If you have any questions, reach out to Logan Kowcheck at lkowcheck@schneiderdowns.com.

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