

IFRS 11 and IFRS 16: Identifying the Customer in a Lease Contract for the Use of Assets by a Joint Arrangement

Extract, IFRS® Discussion Group Report on the Meeting – October 16, 2018

The IFRS Interpretations Committee was asked to clarify the recognition of liabilities by a joint operator in relation to its interest in a joint operation. Specifically, the issue relates to the recognition of liabilities by the lead operator.

The Group considered the fact pattern discussed by the IFRS Interpretations Committee.

Fact Pattern 1

- A number of parties establish a joint arrangement by entering into a joint operating agreement. The joint arrangement is not structured through a separate vehicle, and therefore is classified as a joint operation in accordance with paragraph B16 of IFRS 11 *Joint Arrangements*. Each of the parties is a joint operator as defined in IFRS 11.
- The joint operating agreement sets out the terms upon which the joint operators participate in the activity that is subject to the arrangement. The agreement outlines several aspects, including that one of the joint operators is the lead operator. The lead operator manages the day-to-day activities of the joint operations and enters into contracts with third parties. It also specifies how the joint operators share the assets and liabilities, revenues and expenses, in relation to the joint operation.
- The lead operator enters into a lease, as the sole signatory, for an item of property, plant and equipment to be used as part of the relevant activities of the joint operation throughout the term of the lease. The lead operator is liable for the lease payments to the lessor.
- In accordance with the joint operating agreement, the lead operator also has the right to recover a share of the lease costs from the other joint operators.

Analysis

In its [September 2018 IFRIC® Update](#), the IFRS Interpretations Committee issued a tentative agenda decision, observing that the liabilities a joint operator recognizes include those for which it has primary responsibility. This is based on the requirement in paragraph 20(b) of IFRS 11 that requires a joint operator to identify and recognize 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 operation.

In addition, 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.

For this fact pattern, the lead operator has a present obligation to pay the lessor the lease payments in full, and consequently would recognize 100 per cent of the lease liability. The IFRS Interpretations Committee also noted that the lead operator has a right to recover its proportion of those lease payments from the other joint operators in accordance with the joint operating agreement.

It is also important to disclose information about a joint operation that is sufficient for a financial statement user to understand the activities of the joint operation and a joint operator's interest in that operation. This disclosure is required in accordance with paragraph 20(a) of IFRS 12 *Disclosure of Interests in Other Entities*.

The Group's Discussion

Group members observed that in practice, the terms and conditions in a joint arrangement can differ widely. As a result, it is important that entities carefully consider their specific facts and circumstances to determine the appropriate accounting. For Fact Pattern 1, the Group acknowledged that it is reasonable for the lead operator to recognize 100 per cent of the lease liability given the limited facts specified in the submission to the IFRS Interpretations Committee.

The Group briefly discussed the possibility of a sublease between the lead operator and the other operators in such a leasing situation. In assessing whether there is a sublease, an entity would need to carefully consider the specific facts and circumstances. For example, an entity should consider whether the lead operator (as the potential sub-lessor) has legal recourse against the other parties in the joint arrangement and whether the lead operator has complete control of the asset to direct its use without input from the other parties to sublease the asset. Therefore, careful analysis of the terms and conditions is needed before a conclusion can be made that there is a sublease. An additional point was made that sometimes not all parties to the joint arrangement have the information to know that a sublease exists. However, lack of information is not a basis for non-recognition if a sublease exists.

In some arrangements, there could be cost recovery provisions as well. A lead operator may have a right of recovery in the joint arrangement that could give rise to an asset, but the timing of when to recognize such an asset is very dependent of facts and circumstances. A Group member noted that even if a sublease is present, it would be inappropriate for the lead operator to offset its right of recovery against the obligation to the lessor. The key point in the tentative agenda decision is that, based on the fact pattern submitted, the lead operator is still legally obligated to the lessor even if the lead operator fails to recover the lease payments from the other joint operators.

There was also a brief discussion from the lessor's perspective. If the lessor had legal recourse against the other joint operators in the arrangement for any unpaid lease payments, the accounting outcome could be different. An observation was made that variations in the fact pattern could influence the accounting outcome, including the determination of who is the customer in the joint arrangement. Paragraph B11 of IFRS 16 *Leases* considers this point because it describes a situation in which a contract to receive goods or services may be entered into by a joint arrangement, or on behalf of a joint arrangement.

The Group then considered a second fact pattern in which the joint operation is incorporated.

Fact Pattern 2

- Parties X, Y and Z establish joint operation K as an incorporated vehicle with its own legal identity to explore a mineral interest.
- K enters into a two-year contract with Supplier R for the use of a drilling rig. The contract meets the definition of a lease under IFRS 16 *Leases*. All parties to the arrangement jointly make all decisions about when and where to use the rig, as well as geographical targets to test.

Analysis

Paragraph B11 of IFRS 16 states:

“A contract to receive goods or services may be entered into by a joint arrangement, or on behalf of a joint arrangement, as defined in IFRS 11 *Joint Arrangements*. In this case, the joint arrangement is considered to be the customer in the contract. Accordingly, in assessing whether such a contract contains a lease, an entity shall assess whether the joint arrangement has the right to control the use of an identified asset throughout the period of use.”

In this fact pattern, K is the customer because it entered into the contract on its own, and will be considered the lessee in the lease with Supplier R. Since the joint arrangement is a joint operation, each of the joint operators would recognize its share of the right-of-use asset and lease liability as prescribed for joint operations in IFRS 11.

The Group's Discussion

Group members agreed with the above analysis, although observing that incorporated joint operations are not prevalent in Canada. A few Group members noted that when an incorporated entity exists in a joint operation, the joint operators typically cannot contract into a gross entitlement position in accounting for the assets or liabilities of the incorporated joint operation. That said, some joint operating agreements can be very specific in distinguishing the responsibilities each joint operator has with respect to the joint operations' liabilities. Careful analysis is required to support an incorporated entity being accounted for as a joint operation. One Group member commented that in performing such analysis, an entity could first start with the accounting by the incorporated entity (i.e., in this fact pattern, Entity K would account for the right-of-use asset and lease liability). The secondary question is how the various parties in the joint arrangement would account for the incorporated entity by assessing the terms of the contractual arrangement and other facts and circumstances. Disclosures about an entity's interest in a joint arrangement are particularly important so that financial statement users understand the rights and obligations each party has in a specific situation.

Overall, the Group's discussion raises awareness about this item. The Chair of the Group noted that the staff of the AcSB will be responding to the tentative agenda decision, taking into consideration the Group's discussion. Stakeholders were encouraged to follow the IFRS Interpretations Committee's deliberations relating to the finalization of the tentative agenda decision. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the [audio clip](#)).