

Oil & Gas

Metals & Mining

Applying IFRS

# Accounting for leases relating to a joint operation

September 2019



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## What you need to know

- ▶ The IFRS Interpretations Committee agenda decision makes it clear that where an operator of a joint operation has primary responsibility for a lease, it should recognise 100% of the lease liability.
- ▶ When determining how to account for contractual arrangements between lead operators and the joint operation, all relevant facts and circumstances that provide information as to the enforceable rights and obligations, will need to be assessed.
- ▶ The laws governing those arrangements will also need to be considered.
- ▶ Contractual arrangements are likely to differ between joint operations and legal jurisdictions.

## Highlights

Earlier this year, the IFRS Interpretations Committee (IFRS IC) discussed a question relating to lease arrangements in a joint operation (JO) under IFRS 16 *Leases*. The question asked was how a lead operator (the party responsible for undertaking the operations on behalf of the other joint operators) recognises a lease liability. The question specifically focused on situations where the JO is not structured through a separate vehicle and the lead operator, as the sole signatory, enters into a lease contract with a third party supplier (lessor) for an item of property, plant and equipment that will be operated jointly as part of the JO's activities. The lead operator has the right to recover a share of the lease costs from the other joint operators in accordance with the contractual and other arrangements governing the JO.

The IFRS IC concluded that in accordance with IFRS 11 *Joint Arrangements*, a joint operator identifies and recognises both:

- (a) Liabilities it incurs in relation to its interest in the JO; and
- (b) Its share of any liabilities incurred jointly with other parties to the joint arrangement.

The IFRS IC observed that identifying the liabilities a joint operator incurs and those incurred jointly requires an assessment of the terms and conditions of all contractual agreements that relate to the JO, including consideration of the laws pertaining to those agreements<sup>1</sup>. It also acknowledged contractual agreements relating to each JO are likely to differ.

The IFRS IC further observed, in accordance with IFRS 11, the liabilities a joint operator recognises include those for which it has primary responsibility.<sup>2</sup> Therefore, as sole signatory and where a lead operator has primary responsibility for a lease, the lead operator recognises 100% of the lease liability.

The IFRS IC concluded that the principles and requirements in IFRS standards provide an adequate basis for the lead operator to identify and recognise its liabilities in relation to its interest in a JO and, consequently, the IFRS IC decided not to add this matter to its standard-setting agenda.<sup>3</sup> However, the agenda decision did not address some of the related issues that often arise in these situations.

The objective of this publication is to explore and discuss some of these issues and the potential considerations for arrangements between lead operators and the other joint operators (referred to as non-operator parties) of a JO. It considers how these should be assessed and accounted for under IFRS.<sup>4</sup>

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<sup>1</sup> IFRS IC March 2019 agenda paper 9 "Liabilities in relation to a joint operator's interest in a joint operation (IFRS 11)" paragraph 30(a).

<sup>2</sup> IFRS IC March 2019 agenda paper 9 "Liabilities in relation to a joint operator's interest in a joint operation (IFRS 11)" paragraph 30(b).

<sup>3</sup> IFRIC Update March 2019.

<sup>4</sup> When considering the implications of these issues from a US GAAP perspective, while the IFRS and US GAAP lease standards are aligned with respect to the definition of a lease, there is no equivalent US standard to IFRS 11 when accounting for joint arrangements. Also, as noted above, contractual arrangements can and will differ between JO's and legal jurisdictions. Given this, it cannot be assumed the issues identified in this publication and the analysis that would be required to determine the accounting under IFRS would be the same under US GAAP.

# 1. Background

In certain sectors, particularly mining and metals and oil and gas (extractives industries), it is common for a group of entities to collaboratively perform exploration, development and/or production activities using a JO.<sup>5</sup> In such circumstances, a single party will often be appointed to be responsible for undertaking the operations on behalf of parties to the JO (i.e., the lead operator). The arrangement is often governed by a joint operating agreement (JOA). There may also be other contractual arrangements that govern the relationship and activities between the non-operator parties and the lead operator, some arrangements may involve specific agreements such as rig sharing agreements, and these may be verbal or written.

Therefore, there are potentially a range of enforceable contracts and other agreements that govern the relationship, and other facts and circumstances, that need to be assessed when determining the rights and obligations of the parties and hence the accounting.

As noted above, one issue highlighted during the implementation of IFRS 16, was how a lead operator should recognise lease-related assets and liabilities when it is the sole signatory to a contract that is or contains a lease. The IFRS IC's agenda decision observed that the liabilities a joint operator recognises include those for which it has primary responsibility.

The agenda decision concludes that the liabilities a joint operator recognises include those for which it has primary responsibility

This means if the lead operator is the primary obligor in a lease arrangement, even when the underlying asset will be used to satisfy the activities of the JO, the lead operator should account for the lease by recognising the full lease liability measured in accordance with IFRS 16. In this circumstance, even though the lead operator has a right to recover costs from the non-operator parties, including their share of the lease obligation, it is not appropriate for the lead operator to only recognise its proportionate share of the lease liability by relying on the terms and conditions of the JOA or other arrangements with the non-operator parties to which the third party supplier is not a party. This is because the JOA and other arrangements are separately negotiated with the non-operators and do not extinguish the lead operator's obligation for the lease with the third party supplier.

Determining whether a lead operator, each joint operator party, or the JO itself, has primary responsibility for obligations such as a lease liability, may require a detailed evaluation of all relevant terms and conditions and facts and circumstances, including the legal environment in which the arrangement(s) operate.

The IFRS IC's agenda decision only addresses the accounting for lease liabilities in relation to a joint operator's interest in a JO. The IASB staff papers presented to the September 2018 and March 2019 IFRS IC meetings considered some of the related issues, including a lead operator's right to seek reimbursement of such lease-related expenses from non-operator parties. For example, the IASB staff papers explored, at a high level, whether contractual arrangements between the lead operator and the JO could contain a sublease with respect to an underlying asset leased by the lead operator. However, these matters were not discussed by the IFRS IC in September 2018, and were not addressed in the agenda decision finalised in March 2019.

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<sup>5</sup> Appendix A of IFRS 11 defines a joint operation as a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities, relating to the arrangement.

This publication primarily explores some of the potential considerations for arrangements between lead operators and non-operator parties of a JO where the lead operator has a lease with a third party supplier for which it has primary responsibility, particularly in relation to their respective rights and obligations. However, similar issues may arise where the lead operator owns the asset used on a JO. It considers a range of factors that may need to be assessed when determining how to account for these contractual arrangements, and acknowledges different conclusions could be reached for different joint arrangements and in different jurisdictions.

There may also be some similar concerns, i.e., identification of a lease and other consequential impacts, where the lead operator and the non-operator parties (together, the parties to the JO) enter into an arrangement directly with a third party supplier. However, this is not the primary focus of this publication.

For more information on accounting for leases, refer to our *Applying IFRS: A closer look at IFRS 16 Leases*.<sup>6</sup>

## 2. Related issues for consideration

In the extractives sectors, a JOA (and/or related contractual arrangements) generally provides the lead operator with a right to recover the costs it incurs on behalf of the non-operator parties, including costs related to leasing assets to be used in the JO. Some stakeholders may have previously considered that the right to recover costs pursuant to a separately negotiated JOA meant that the lead operator was only required to recognise a lease liability incurred as part of a contract with a third party supplier (lessor) in proportion to its interest in the JO. However, as noted above, the IFRS IC concluded in the fact pattern it was presented, that the JOA and related contractual arrangements did not extinguish or transfer the lead operator's primary responsibility for the lease liability.<sup>7</sup>

As a result, the IFRS IC observed the liabilities that a joint operator recognises include those for which it has primary responsibility. As a direct consequence of this decision, the immediate issue is then to determine who has primary responsibility for the arrangement with the third party supplier (see Section 2.1).

Where it is determined that the lead operator has primary responsibility (similar to the fact pattern presented to the IFRS IC), the potential follow-on issues to consider include, but may not be limited to:

- ▶ Who is the customer (see Section 2.2)
- ▶ Whether the arrangement between the lead operator and the JO is, or contains, a sublease (Section 2.3)
- ▶ Depending on the conclusion reached in Section 2.3, determining the appropriate accounting by the lead operator (Section 2.4) and the non-operator parties (Section 2.5)

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<sup>6</sup> The publication is available on [www.ey.com/ifrs](http://www.ey.com/ifrs).

<sup>7</sup> IFRS IC March 2019 agenda paper 9 "Liabilities in relation to a joint operator's interest in a joint operation (IFRS 11)" paragraph 28.

## 2.1 Determining who has primary responsibility

Determining whether a lead operator, each party to the JO or the JO itself, has primary responsibility for obligations, such as a lease liability, may require a careful evaluation of all relevant terms and conditions as well as facts and circumstances and the legal environment in which the arrangement(s) operate.

When assessing the fact pattern presented to the IFRS IC, the analysis in the March 2019 paper<sup>8</sup> specifically focused on the derecognition requirements of IFRS 9 *Financial Instruments*. The paper noted that an entity could only derecognise a liability when it was extinguished, i.e., when the entity discharges the liability or is legally released from primary responsibility for the liability either by process of laws or by the creditor.

It also referred to the considerations the IASB undertook when developing IFRS 16 and whether an intermediate lessor should be permitted to offset payments received under the sublease against the liability recognised on the head lease. The IASB decided not to permit this on the basis that each contract was negotiated separately, with the counterparty to the sublease being different to the counterparty to the head lease. As such, the obligations arising from the head lease were generally not extinguished by the terms and conditions of the sublease. This analysis indicated that the legal form of the arrangements is essential in determining who has primary responsibility. As noted above, the outcome may vary depending on the legal jurisdiction in which the arrangements operate.

Where it is established the lead operator has primary responsibility, the IFRS IC decision made it clear that the lead operator will initially recognise the entire lease liability and related ROU asset in accordance with IFRS 16.

Before undertaking the lease assessment set out in Section 2.3, it is critical to first determine who the customer is. This is because a lease arises when a customer has a right to control the use of an identified asset for a period of time in exchange for consideration.

## 2.2 Identifying the customer where there is a JO

Once it has been established the lead operator has primary responsibility for the lease arrangement with the third party supplier, it is then necessary to assess the arrangement(s) between the lead operator and the JO. In undertaking this assessment, it is important to remember that where there is a joint arrangement, IFRS 16 makes it clear that for the purposes of identifying a lease, it is the JO that is the customer in the arrangement with the lead operator rather than each of the parties to the JO individually.<sup>9</sup>

However, the IFRS IC staff paper also noted IFRS 16.B11 was developed to apply only when assessing whether a contract contains a lease and determining who the “customer” is as per the requirements of IFRS 16. It has no further effect on the required accounting for the lease or the joint arrangement, or when assessing who is the customer for the purposes of other standards.<sup>10</sup>

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<sup>8</sup> IFRS IC March 2019 Agenda paper 9: “Liabilities in relation to a joint operator’s interest in a joint operation (IFRS 11)” paragraphs 35-39.

<sup>9</sup> IFRS 16.B11 specifically states that when a contract to receive goods or services is entered into by a joint arrangement [as defined in IFRS 11], or, on behalf of a joint arrangement, for the purpose of a lease assessment, the joint operators to the joint arrangement, collectively, are considered to be the customer in the contract.

<sup>10</sup> IFRS IC March 2019 Agenda paper 9: “Liabilities in relation to a joint operator’s interest in a joint operation (IFRS 11)” paragraph 17; and IFRS IC Agenda September 2018 paper 3: “IFRS 11 *Joint Arrangements* - joint operations” paragraphs 40-44.

Refer Section 2.4.2 for further discussion of where the term customer is used in other standards.

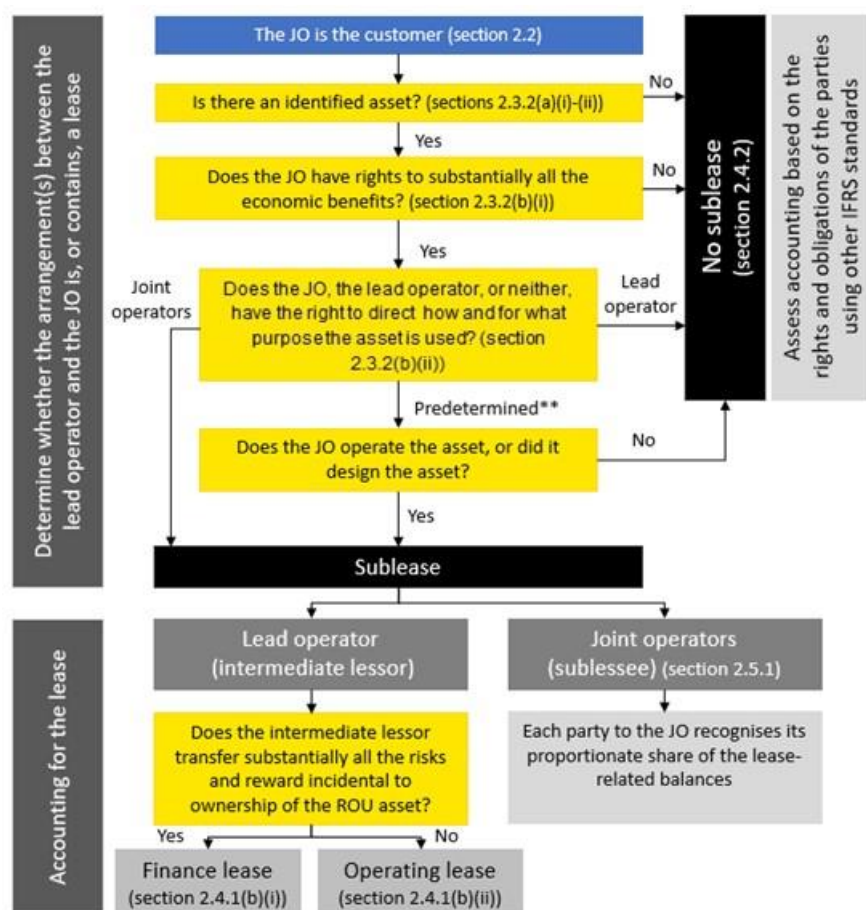
### 2.3 Does the contractual arrangement between the lead operator and the JO contain a sublease?

When assessing the nature of the relationship between the lead operator and the JO and the potential consequential accounting outcomes, including whether there is a sublease, all relevant enforceable contracts, facts and circumstances and the relevant legal environment, need to be considered.

Section 2.3.1 below sets out some examples of potential contracts that may need to be considered when identifying relevant facts and circumstances and enforceable rights and obligations. Section 2.3.2 then discusses some of the factors that need to be assessed to determine whether there is a sublease arrangement in place.

This overall assessment process is summarised in the following flow chart:

**Flowchart 1: Determining whether the contractual arrangements between the lead operator (as the supplier) and the JO (as the customer) is, or contains, a sublease; and the subsequent accounting for the arrangement**



\*\* see section 2.3.2(b)(iii) for discussion of the concept of "predetermined".

There are a range of arrangements between a lead operator and the joint operation that may need to be considered

### 2.3.1 Assessing the contractual arrangements between the lead operator and the non-operator parties to the JO

#### *Joint operating agreement*

It is common in the extractives industries for a JOA to exist between the parties to the JO. Depending on the terms of the JOA, the underlying activities may be determined and governed by the field/mine development plan and/or the annual operating plans and these may require the unanimous consent or a majority vote of the parties to the JO. In other instances, the JOA may not be explicit as to how all aspects of the JO will operate, particularly when it comes to determining which party (i.e., the lead operator or the JO) has the right to control the use of the assets used to perform the activities of the JO. In other instances the JOA may give the lead operator primary authority over the development and operations plan for the field/mine and/or the right to determine the relevant decisions over certain assets (e.g., the right to determine when and whether specific assets will be used in the development and operations plan).

As JOAs can vary between JOs and across jurisdictions as they relate to control and responsibility for the activities pursuant to the development and operations plan, each arrangement needs to be carefully considered based on individual facts and circumstances to identify the enforceable rights and obligations.

#### *Other enforceable contractual arrangements (written and verbal)*

Other enforceable contractual arrangements, written and/or verbal, may also affect the rights and obligations of the lead operator and the non-operator parties and thus need to be taken into consideration. For example, for significant assets such as a deepwater drilling rig that is integral to the activities of the JO, a separate contractual arrangement between the lead operator and non-operator parties may exist. This may have been required to evidence the non-operator parties' agreement to the use of the specific drilling rig and specific contractual terms including the payment terms, prior to the lead operator entering into the lease arrangement with the third party lessor. This may take the form of a written agreement, or, for example, could be via enforceable verbal agreements reached through the operating committee meetings of the JO which are then minuted.

#### **How we see it**

- ▶ The extent and nature of contractual arrangements can vary between JOs and relevant legal environments in different jurisdictions.
- ▶ The specific facts and circumstances and enforceability of each contractual arrangement need to be considered to determine the rights and obligations of the lead operator and the JO.



### 2.3.2 Determining if there is a sublease

Once it has been established there is a customer-supplier relationship between the lead operator and the JO, the next step is to determine whether there is a lease.

IFRS 16 states that a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.<sup>11</sup> In assessing 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 both:

- ▶ The right to obtain substantially all of the economic benefits from use of the identified asset

And

- ▶ The right to direct the use of the identified asset

The key factor to determine whether there is a sublease is whether it is the lead operator (as the supplier) or the JO (as the customer) that has the right to control the use of the identified asset.

#### **(a) Is there an identified asset?**

##### *(i) Specified asset - explicit or implicit*

The first step in a lease assessment is to determine if there is an identified asset. As noted earlier, this assessment will be the same irrespective of whether the asset in question is owned or leased by the lead operator. However, the focus of this publication is on situations where the asset in question is leased by the lead operator from a third party supplier.

An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that it is made available for use by the customer. A capacity or other portion of an asset, that is not physically distinct, may be an identified asset if the customer's rights to use that asset represent substantially all of the capacity of the asset and thereby provide the customer with the right to obtain substantially all of the economic benefits from use of the asset. For example, a capacity portion of a pipeline or processing plant being used by the JO, could be an identified asset if the portion represents substantially all of the capacity, even if it is not physically distinct.

When analysing the contractual arrangement between the lead operator and the third party supplier, if a capacity or other portion of an asset has been appropriately evaluated, the right to use the asset still needs to be assessed to determine whether it is an identified asset for the purpose of evaluating the existence of a sublease between the lead operator and the JO. This assessment will be based not only on the enforceable terms and conditions of the contractual arrangement between the lead operator and the non-operator parties, but also other relevant facts and circumstances<sup>12</sup>, inclusive of supplier substitution rights (see Section 2.3.2(a)(ii) below for a discussion on substantive substitution rights).

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<sup>11</sup> IFRS 16.9.

<sup>12</sup> IFRS 16.2.

#### Illustration 1 – identified asset – explicitly identified

A lead operator enters into a lease with a third party supplier for the use of an identified drilling rig for a period of three years. This drilling rig is to be used on JO1 for the full three-year period and this has been discussed and agreed between all parties to the JO at its Operating Committee (OpComm) and has been documented in the OpComm meeting minutes, which are enforceable under this JOA and for this jurisdiction. The lead operator has no substantive substitution rights with respect to this drilling rig throughout the three-year term of the arrangement with JO1.

*Analysis:* The drilling rig is an identified asset. The drilling rig is explicitly specified in OpComm meeting minutes, and there are no substantive substitution rights.

#### Illustration 2 – identified asset – capacity portion of an asset

A lead operator enters into a lease with a third party supplier for the right to use an explicitly specified iron ore processing plant for three years. The lead operator then uses this processing plant to process iron ore received from multiple JO's, including JO1. The JOA between the lead operator and JO1 requires the lead operator to undertake all iron ore processing activities using the processing plant which the lead operator has leased. Given the quantity of JO1's iron ore which needs to be processed and the capacity of the processing plant, this arrangement provides JO1 with the right to substantially all of the processing plant's capacity. The lead operator has no substantive substitution rights with respect to this processing plant.

*Analysis:* The processing plant is an identified asset. While the capacity portion of the processing plant is not physically distinct, as JO1 has the right to substantially all of the processing plant's capacity, JO1 has the right to obtain substantially all of the economic benefits from use of the processing plant. Also, there are no substantive substitution rights.

#### (ii) *Substantive substitution rights*

IFRS 16 states that 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.<sup>13</sup> In determining whether the lead operator has the substantive right to substitute the asset throughout the period of use, it will be necessary to consider whether the lead operator has the practical ability to substitute (e.g., due to having a portfolio of similar underlying assets which it owns or leases and can easily substitute), and, whether it would benefit economically from doing so.

Demonstrating there is an economic benefit from substitution is a high hurdle, as the customer (i.e., the JO) has to be able to demonstrate the supplier has the practical ability to substitute the underlying asset and the supplier's economic benefits associated with substituting the asset, throughout the period of use, would exceed its costs. If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer presumes the right is not substantive.<sup>14</sup>

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<sup>13</sup> IFRS 16.B14.

<sup>14</sup> IFRS 16.B19.

### Illustration 3 – identified asset – explicitly identified but multiple assets available

A lead operator enters into a lease with a third party supplier for the use of helicopter XYZ for a period of three years. The lead operator plans to use helicopter XYZ for flights to and from JO1 (a remote mining operation) for the full three-year period. The use of helicopter XYZ has been agreed between the lead operator and the non-operator parties to JO1.

However, while all the parties to JO1 have agreed to use helicopter XYZ, the lead operator also leases two other helicopters of the same specifications, and all three helicopters are retained at the same nearby air base. The minutes from the same OpComm meeting also confirm that to maximise efficiency of operations, the lead operator is permitted to utilise helicopter XYZ on the lead operator's other unrelated nearby JOs and the similar helicopters can be used on JO1 provided each continues to meet specified safety requirements.

The lead operator's lease arrangements with its third party suppliers allows each of the three helicopters leased by the lead operator to be used for flights to and from each of its mining operations.

*Analysis:* The arrangement does not contain an identified asset. The lead operator has substantive substitution rights as it has access to two other helicopters that can fly to and from the JO1 mine site. Also, as the helicopters are of the same specification and are held at the same nearby air base, practically substitution can occur. The lead operator would substitute where it provides for efficiency of operations, and accordingly, an economic benefit would arise from substitution. Therefore, notwithstanding helicopter XYZ is explicitly specified in the minutes to the OpComm meeting for JO1, there is no identified asset as the lead operator has a substantive right of substitution.

### How we see it

- ▶ The existence of a substantive substitution right should be considered on a lease-by-lease basis taking into consideration the specific facts and circumstances existing at lease inception.
- ▶ Given the nature of some assets used within these types of contractual arrangements and the location of the underlying assets, it will often be difficult to demonstrate that the lead operator has a substantive right to substitute the asset under these circumstances. This is because it is likely the lead operator may not have the practical ability to substitute the assets and, even so, costs of substitution would be high. Therefore, it may be difficult to demonstrate, throughout the period of use, that the benefits of substitution are greater than the costs.

**(b) Does the customer have the right to control the use of an identified asset?**

As discussed above at Section 2.2, when applying the requirements of IFRS 16 (as outlined below) and specifically when considering the concept of the customer, it is the JO that is the customer. The JO (as the customer) has the right to control the use of an identified asset if it has both the right to obtain substantially all of the economic benefits from use and the right to direct the use of the asset. It would be inappropriate to conclude that a contract does not contain a lease on the grounds that each of the parties to the JO either 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.<sup>15</sup>

**(i) Right to obtain substantially all of the economic benefits from the use of the identified asset**

To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use (e.g., by having exclusive use of the asset throughout that period).

There may be some situations where there is a difference between an asset's nominal/expected capacity and the capacity expected to be used by the customer. This may impact the assessment of whether a customer has the right to substantially all of the economic benefits from the use of the identified asset.

**Illustration 4 – assessing “substantially all” when the customer’s use of the asset is not 100% of the nominal operating capacity**

A lead operator enters into a 30-year lease with Supplier A to transport gas through a pipeline. The lead operator has the right to use 100% of the pipeline. The lead operator will then use the pipeline to transport gas for JO1. At the commencement of the arrangement with JO1, JO1 has the right to use 70% of the pipeline's nominal capacity. The pipeline is located in a remote area where the probability of another customer using the excess capacity of the pipeline is remote.

*Analysis:* Where the likelihood of another customer using the excess capacity is not substantive, JO1 will be considered to have the right to obtain substantially all of the economic benefits from using the pipeline throughout the period of use.

Determining whether JO1 has the right to obtain substantially all of the economic benefits from using the pipeline throughout the period of use requires consideration of all facts and circumstances. This includes considering the reason for the unused excess capacity.

In this situation, the assessment should be performed based on JO1's right to use 70% of the capacity, combined with an assessment of the likelihood of another customer using the excess capacity.

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<sup>15</sup> IFRS 16.BC 126.

## How we see it

There is a range of factors to take into consideration when determining whether the JO has the right to substantially all of the economic benefits from the use of an asset. These include (but are not limited to):

- ▶ The importance of these types of assets used in the activities of JOs in the mining sector/oil and gas sector and the location of the assets, e.g., in locations which are difficult to get to and/or are remote
- ▶ Whether they are located on the mining entity's/oil and gas entity's property
- ▶ The likelihood of another customer being able to access any excess capacity.

### *(ii) The right to direct the use of the asset*

IFRS 16 states that a customer can obtain the right to direct the use of an identified asset throughout the period of use if the customer has the right to direct how and for what purpose the asset is used throughout the period of use.

When assessing the range of service arrangements used in the mining sector/oil and gas sector, to determine if they are, or contain, leases, it is essential to understand what and who dictates how and for what purpose an identified asset is used. In making this assessment, the decision-making rights most relevant to changing how and for what purpose an identified asset is used throughout the period of use are considered. Decision-making rights are relevant when they affect the economic benefits to be derived from use.

When assessing arrangements between a lead operator and a JO, it is critical to assess whether it is the lead operator or the JO as a whole, that has the right to direct the use of the asset. This involves obtaining an understanding of the JOA and other relevant enforceable arrangements to determine who has the right to make (and change) the key decisions with respect to the use of the asset throughout the period of use.

Under IFRS 11, a joint arrangement exists where:

- ▶ The contractual arrangement gives all the parties, or a group of the parties, control over the arrangement collectively

And

- ▶ The decisions about the relevant activities require the unanimous consent of the parties sharing control<sup>16</sup>

For arrangements in the extractives sectors, under the terms of a JOA, approval of the mine plan or field plan and/or annual operating budget may be considered a relevant activity, and, for this to require unanimous consent of all parties to the JO for approval. Identification of relevant activities and determining which require unanimous consent, is a critical part of the rationale to support joint control such that the arrangement is a joint arrangement in scope of IFRS 11.

When assessing who has the right to direct the use of an asset in accordance with IFRS 16, in some arrangements, the lead operator may retain this right and therefore there will be no sublease between the lead operator and JO.

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<sup>16</sup> IFRS 11.5, 7.

However, if the enforceable terms of the JOA and other arrangements in place and relevant facts and circumstances support this, it is possible the JO may have the right to direct the use of an identified asset(s) used as part of the activities of the JO.

For example, where it has been concluded that the mine plan or field plan is specific enough that it provides the JO the right to determine how and for what purpose an identified asset is used throughout the period of use and subsequent changes to that mine plan or field plan require unanimous consent, then the JO may direct the use of the identified asset. If the JO also has the right to substantially all of the economic benefits from use of the asset, the JO (as the customer) has the right to control the use of the asset.

#### Illustration 5 – right to direct the use - dedicated asset

Company A, in its role as lead operator, enters into a 10-year lease (head lease) for a Floating Production Storage Offloading (FPSO) vessel with a third party supplier, as sole signatory and has primary responsibility for the lease payments. It recognises the entire lease liability and related ROU asset in respect of the head lease. The FPSO is highly specialised to allow for production from a single specified field, owned by JO1, on which it is to be deployed. The FPSO will be used by JO1 for 10 years.

The enforceable terms of the JOA for JO1 specify that the lead operator is responsible for sourcing an appropriate FPSO to be used on JO1 for 10 years. Once identified, the lead operator will not have a substantive right to substitute the underlying FPSO during the 10-year period.

In addition, in this example, the field development and operations plans, which determine how and for what purpose the FPSO is used throughout the period of use, require the unanimous consent of the parties to JO1. Due to changing oil prices, costs, field performance, etc, the parties to JO1 also have the right to change these plans. Therefore, such decisions are the relevant decisions impacting the economic benefits derived from use of the FPSO.

The lead operator recovers its costs related to the lease of the FPSO payable to the third party supplier by billing all parties to JO1, pro-rated based on their equity interests in JO1 throughout the 10 year right of use term.

*Analysis:* There is a sublease between the lead operator and the JO. In this instance, given the enforceable terms of the JOA and other relevant facts and circumstances, the FPSO is implicitly identified and JO1 has the right to substantially all of the economic benefits and has the right to direct the use of the identified FPSO throughout the period of use.

#### Illustration 6 – right to direct the use – asset can be used on multiple locations for multiple JOs

Company B is the lead operator for a range of different JOs, each of which have exploration licences in close proximity to each other. Exploration and appraisal drilling is expected to occur over the two year period. Company B's equity interest in each JO varies. Given expected upcoming drilling activity, Company B enters into a lease with a third party supplier for a drilling rig for a period of two years.

Under the terms of the JOAs governing each of the JOs, Company B is required to execute drilling activity over the coming two years over a number of the licences, but has flexibility in determining the exact timing of drilling to be performed on each respective licence.

Company B has the substantive right to determine when and where to drill for each licence and can change such decisions, throughout the period of use. The JOs have no right to make or change relevant decisions about the use of the asset, even when the drilling rig is currently in use on their respective licences.

Throughout the period in which the rig is drilling on a licence, Company B has the right to recover costs incurred from the respective JOs relative to the equity interests of each of the non-operator parties. When the drilling rig is idle, Company B has no right to recover costs from any JO.

*Analysis:* The arrangements between the lead operator and the JOs do not contain a sublease. In this situation, the lead operator has the right to make the relevant decisions about the use of the drilling rig. Those decisions include determining when and where to use the drilling rig throughout the period of use. No single JO has the right to control the use of the drilling rig over the full two year lease term; rather, Company B has the right to control the use of the drilling rig.

#### Illustration 7 – right to direct the use – asset only used on one JO

Company C is the lead operator for JO2, an onshore field in the development phase. Development drilling is planned for the next 15 months and the field development plan sets out that 30-60 wells will be drilled within a pre-approved budget. Company C has entered into a 15 month lease with a third party supplier to secure a drilling rig for the activity.

Under the terms of the JOA governing JO2, Company C is required to utilise its knowledge of the field to execute the drilling programme that maximises the economics of JO2's development plan. In this example, Company C has the right to determine whether, when and where each well will be drilled within the licence area and has the right to change such decisions, throughout the period of use. JO2 has no right to make or change relevant decisions about the use of the asset.

Throughout the period in which the rig is drilling on the licence, Company C has the right to recover costs incurred from the JO2 non-operator parties relative to their equity interests in the licence.

*Analysis:* The arrangement between the lead operator and the JO does not contain a sublease. In this situation, the lead operator has the right to make the relevant decisions about the use of the drilling rig. In this example, those decisions include determining whether, when and where to use the drilling rig throughout the period of use. In this example, Company C has the right to control the use of the drilling rig throughout the period of use.

*(iii) Right to direct the use is predetermined*

IFRS 16 also considers circumstances whereby the right to direct the use of the asset is “predetermined”. That is, a customer has the right to direct the use of an identified asset throughout the period of use if the relevant decisions about how and for what purpose the asset is used are predetermined and: (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or (ii) the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.<sup>17</sup> The concept of predetermined has not been considered in detail in this publication.

### How we see it

- ▶ There are a range of factors entities will need to consider to determine whether a sublease exists between a lead operator and a JO.
- ▶ Entities need to ensure the evidence used to support conclusions about joint control for the purposes of applying IFRS 11 (in particular, the factors used to conclude that there is a joint arrangement and the lead operator is not controlling the arrangement itself, but instead is just carrying out the decisions of the parties to the joint arrangement), is taken into consideration when determining who has the right to control the use of an identified asset used as part of the JO activities in accordance with IFRS 16, i.e., the lead operator or the JO.

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<sup>17</sup> IFRS 16.B24.



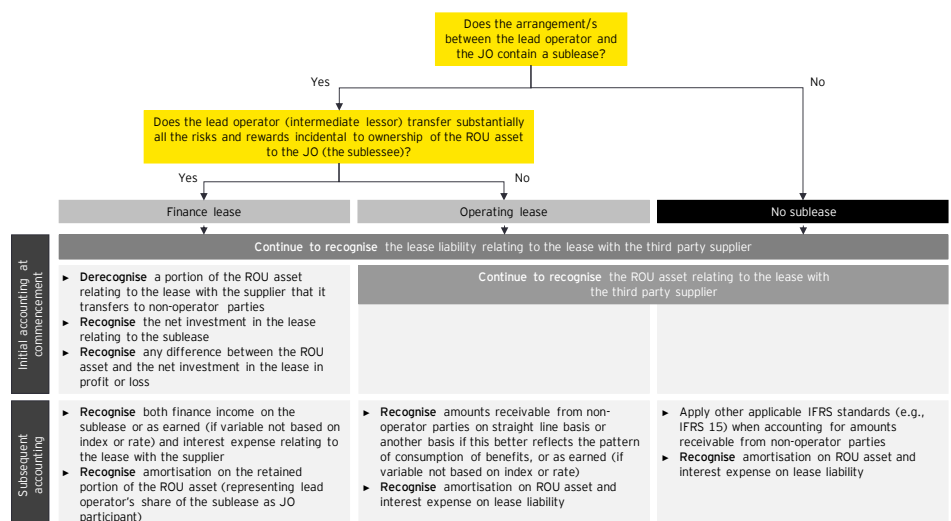
The lead operator will continue to recognise 100% of the lease liability on the lease with the third party supplier if it has primary responsibility

## 2.4 Accounting by the lead operator

Where the lead operator is the sole signatory to, and has primary responsibility for, the contract that is or contains a lease with the third party supplier, the lead operator is required to initially recognise 100% of the ROU asset and the related lease liability in accordance with IFRS 16. Regardless of whether the JOA and related arrangements are considered to contain a sublease, for as long as the lead operator remains a party to the lease arrangement with the third party supplier, the lead operator will continue to recognise 100% of the lease liability. This is on the basis that the JOA and related arrangements do not extinguish or transfer the lead operator's enforceable rights and obligations under the contract with the third party supplier and instead, the lead operator retains the primary responsibility for the lease liability. However, the subsequent accounting for the ROU asset and the accounting for the amounts received or receivable from the non-operator parties will depend on whether a sublease exists, and if there is a sublease, whether it is a finance lease or operating lease.

A summary of the potential outcomes is as follows:

**Flowchart 2: Lead operator's accounting for the contractual arrangement with the JO - potential accounting outcomes**



### 2.4.1 JOA and/or related contractual arrangements are, or contain, a sublease

#### (a) Classifying the sublease

Lessor accounting remains largely unchanged from that prescribed by the previous accounting standard, IAS 17 Leases. Therefore, the lessor needs to determine whether the arrangement transfers substantially all the risks and rewards incidental to ownership of the underlying asset and if so, it is a finance lease. When assessing the lease classification, this is undertaken by reference to the ROU asset arising from the head lease, not by reference to the underlying asset. If the head lease is a short-term lease that the lead operator, as a lessee, has accounted for applying the practical expedient,<sup>18</sup> the sublease is classified as an operating lease.

<sup>18</sup> IFRS 16.6.

For more information on classifying leases by a lessor refer to our *Applying IFRS: A closer look at IFRS 16 Leases*, Section 5.1.<sup>19</sup>

#### Illustration 8 – classifying the sublease – finance lease

Company A, as lead operator of JO1, enters into a 10-year contract with a third party supplier that contains a lease (head lease) for a FPSO vessel as a sole signatory and has primary responsibility for the lease payments. Therefore, the lead operator recognises 100% of the lease liability and the related ROU asset.

The FPSO is used on JO1 and for the purposes of this illustration, it has been concluded that the arrangement contain a 10-year sublease.

The FPSO is highly specialised to allow for production from a single specified license, owned by JO1, on which it is to be deployed, and hence can only be used by JO1 (as the sublessee), without major modifications. The FPSO has an estimated useful life of 25 years.

*Analysis:* The sublease is classified as a finance lease. The sublease is classified by reference to the ROU asset in the head lease and not the underlying FPSO. The lease term for the sublease represents all (and hence a major part) of the life of the ROU asset, as the sublease is for 10 years and the tenure of the ROU asset is also 10 years. Furthermore, the asset is specialised in nature.

#### Illustration 9 – classifying the sublease – operating lease

Company A, as lead operator of JO1, enters into a contract with a third party supplier that contains a lease of an excavator for five years (head lease). The excavator is not specialised.

For the purposes of this illustration, it has been concluded the arrangement contains a 2-year sublease of the excavator.

*Analysis:* The sublease is classified as an operating lease. The sublease is classified with reference to the ROU asset in the head lease and not the underlying excavator. The lease period does not represent a major part of the life of the ROU asset, because the sublease is only for two years and the ROU asset is for five years. Also, there are no other factors in this example which would indicate there is a finance lease.

### **(b) Accounting for the sublease**

#### **(i) Finance lease**

**At commencement of the sublease:** the lead operator, as intermediate lessor:

- ▶ Derecognises a portion of the ROU asset which had been recognised in relation to the lease with the third party supplier – the portion derecognised represents the portion of the ROU asset transferred to the non-operator parties
- ▶ The portion of the ROU asset retained represents the lead operator's share of the sublease as a participant in the JO recognised in accordance with IFRS 11

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<sup>19</sup> The publication is available on [www.ey.com](http://www.ey.com).

- ▶ Recognises a net investment in the lease - the net investment in the lease is measured as the sum of the discounted lease payments receivable from the non-operator parties in respect of the sublease and any unguaranteed residual value in the ROU asset accruing to the lead operator as intermediate lessor
- ▶ Recognises any difference between the portion of the ROU asset derecognised and the net investment in the lease recognised in profit or loss
- ▶ Continues to recognise the existing lease liability relating to the lease with the third party supplier in its statement of financial position, which represents the lease payments it owes to the third party supplier as the head lessor

**During the term of the sublease:** the lead operator, as the intermediate lessor, recognises finance income on the sublease (net investment in the lease), amortisation of its share of the ROU asset which is retained in its books and interest expense on the lease liability relating to the head lease. For more information on accounting for finance leases by a lessor refer to our *Applying IFRS: A closer look at IFRS 16 Leases, Section 5*.<sup>20</sup> Any variable lease payments that do not depend on an index or rate (e.g., performance- or usage- based payments) are recognised as earned.

#### Illustration 10 – accounting for the sublease - finance lease

Assume the lead operator recognises a ROU asset and lease liability of \$100 on a head lease (assume there were no other adjustments required against either of these balances), and the arrangement between the lead operator and the JO contains a sublease classified as a finance lease.

The lease term for the head lease and sublease are both 10 years, have the same commencement dates, and the timing and amounts of the lease payments are identical.

The lead operator remains primarily obligated for the lease, including the lease payments under the head lease.

The lead operator (as a participant in the JO) has a 40% interest in the JO. The entries recognised by the lead operator will be, as follows:

##### Commencement of the head lease

Dr ROU asset	100	
	Cr Lease liability (head lease)	100

*Journal entry to recognise the head lease determined using the sum of the discounted lease payments.*

<sup>20</sup> The publication is available on [www.ey.com](http://www.ey.com).

#### Illustration 10 – accounting for the sublease - finance lease (cont'd)

##### Commencement of the sublease

Dr Net investment in the lease	60
Cr ROU asset	60

*Journal entry to derecognise a portion of the ROU asset relating to the head lease equal to the non-operators' interests in the lease between the lead operator and the JO and recognise the discounted value of the sum of the related amounts receivable from the non-operator parties*

##### Net impact for lead operator

Dr ROU asset <sup>#</sup>	40
Dr Net investment in the lease	60
Cr Lease liability (head lease)	100

<sup>#</sup> *The ROU asset retained by the lead operator represents the lead operator's 40% share of the lease between itself and the JO which it recognises because it is also a participant in the JO*

#### (ii) Operating lease

**At lease commencement:** the lead operator, as intermediate lessor:

- ▶ Continues to recognise the ROU asset relating to the lease with the third party supplier
- ▶ Continues to recognise the lease liability relating to the lease with the third party supplier in its statement of financial position, which represents the lease payments it owes to the third party supplier as the head lessor

**During the term of the sublease:** the lead operator, as the intermediate lessor, recognises amortisation of the ROU asset and interest expense on the lease liability relating to the lease with the third party supplier. It also recognises payments received from the non-operator parties as income, on either a straight-line basis or another systematic basis if that better represents the pattern in which benefit is expected to be derived from the use of the asset. Any variable lease payments that do not depend on an index or rate (e.g., performance- or usage- based payments) are recognised as earned.

#### 2.4.2 JOA and/or related contractual arrangements are not, do not contain, a sublease

When the contractual arrangements between the lead operator and the JO do not contain a sublease, the lead operator continues to recognise the ROU asset and related lease liability in relation to the lease with the third party supplier at lease commencement and will recognise amortisation of the ROU asset and interest on the lease liability across the term of the lease.

The arrangement with the JO will then likely represent an executory contract and the accounting by the lead operator for amounts receivable from the non-operator parties will depend on the nature of this arrangement. Some of the potential accounting considerations may include the matters listed below. When undertaking these assessments, as discussed at Section 2.2 above, it is important to note that the determination of the customer for the purposes of applying IFRS 16 does not necessarily impact the determination of a customer for the purposes of other standards. For example, a customer, for the purposes of IFRS 15 *Revenue from Contracts with Customers* (IFRS 15), is determined by applying the specific requirements and guidance of IFRS 15.

- ▶ **Provision of JO management services whereby the JO is considered to be a customer:** the arrangement will be in the scope, and the lead operator will apply the provisions, of IFRS 15. Revenue will be recognised at the amount the lead operator expects to be entitled to in exchange for providing the JO management services to the JO as the relevant performance obligations are satisfied. Refer our *Applying IFRS – A closer look at IFRS 15, the revenue recognition standard*<sup>21</sup> for more information on factors to consider when applying IFRS 15.
- ▶ **JO does not represent a customer:** where the lead operator does not consider it is providing JO management services to the non-operator parties within the scope of IFRS 15, the lead operator will need to apply other relevant IFRS standards, or when no specific IFRS standards are applicable, use judgement to determine the appropriate accounting treatment for the arrangement. The lead operator will need to apply IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to determine the nature of the relationship and whether and when it should recognise amounts receivable from the non-operator parties. Specifically, the lead operator will need to assess whether the provisions of IFRS 9 *Financial instruments* relating to financial assets apply or whether the reimbursement requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* apply. The lead operator will also need to assess whether these amounts represent a form of income or a direct reimbursement of expenditure.

### 2.4.3 Other issues to consider

In addition to the above, there are a number of other potential issues that a lead operator may need to consider when evaluating the overall accounting implications, which include but are not limited to:

- ▶ **Capitalisation of costs:** where the activities of the JO are being undertaken in relation to a project that is in the exploration and evaluation (E&E) phase or the development phase, depending on the lead operator's accounting policies, it may need to consider whether some of the costs incurred, e.g., a portion of the amortisation of the ROU asset and/or interest expense on the lease liability, should be capitalised. The lead operator will need to assess whether such costs meet the requirements for capitalisation under the relevant standards (including IAS 23 *Borrowing Costs*, which explicitly scopes in interest in respect of leases under IFRS 16), and if so, determine the amount that should be capitalised versus the amount that should be expensed.

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<sup>21</sup> This publication can be found on [www.ey.com/ifrs](http://www.ey.com/ifrs).

- ▶ **Mismatch between the lead operator's costs and the amounts receivable from the non-operator parties:** in each period, the lead operator's accounting for the expenses relating to the lease with a third party which are to effectively be reimbursed by the non-operator parties, will not necessarily be equivalent to the amounts receivable from the non-operator parties. This is because the IFRS 16 accounting for the lease with the third party supplier will generally be more front ended and will comprise amortisation of the ROU asset and interest on the lease liability. This will differ from the income a lead operator will recognise under sublease operating accounting or executory contract accounting. This will lead to timing mismatches for the lead operator in its profit or loss.
- ▶ **Presentation of amounts receivable from the non-operator parties (where the arrangement is not a "sublease which is a finance lease", i.e., it is either an operating lease or not a sublease):** in this situation, a question that may be asked is whether any amounts receivable from the non-operator parties can be offset against the amounts recognised by the lead operator. This question is generally raised because from an economic perspective, the non-operator parties are effectively paying their respective share of the cash costs incurred by the lead operator on the lease with the third party supplier. Hence, some lead operators may prefer to present the effects of this on a net basis, if / where possible.

When assessing this offsetting issue, the following needs to be considered:

- ▶ **Ability to offset:** IAS 1 *Preparation of Financial Statements* (IAS 1)<sup>22</sup> and the Conceptual Framework<sup>23</sup> provide the requirements and guidance with respect to offsetting of assets and liabilities and income and expenses. IAS 1 states offsetting is not allowed unless required/permitted by another standard and the Conceptual Framework notes it is generally not permitted as offsetting classifies dissimilar items together. Given this, it is expected the ability to achieve offsetting will be rare.
- ▶ **Lead operator capitalises its costs as part of an E&E or development asset:** in such a situation, the lead operator would only be able to capitalise the portion of the costs incurred on the head lease relating to its ownership in the JO assets. This is on the basis that it would not receive the future economic benefits associated with the costs attributable to the non-operator parties. These costs would therefore need to be recognised in profit or loss (P&L). Refer below for further discussion on the issues this would present.
- ▶ **Lead operator recognises its costs in P&L:** in this situation, the question is whether the lead operator can offset the amounts receivable from non-operator parties directly against the line items within P&L in which it has recognised the costs relating to the lease with the third party supplier. The challenges here may include:
  - ▶ Mismatches in amounts (as discussed above)
  - ▶ Whether such amounts received can be offset and if so, upon what basis

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<sup>22</sup> IAS 1.32.

<sup>23</sup> Conceptual Framework 7.10.

- ▶ If a valid argument could be mounted to support offsetting, which is considered difficult to achieve, given the lead operator will be recognising amortisation and interest, it is unclear how the amounts received would be allocated between the two line items

## 2.5 Accounting by the non-operator parties

As discussed in Section 2.4 above, where the lead operator is the sole signatory to, and has primary responsibility for, the contract that is or contains a lease with the third party supplier, the lead operator is required to initially recognise 100% of the lease-related balances. The accounting by the non-operator parties will then depend on whether the JOA and/or related contractual arrangements contain a sublease or not.

### 2.5.1 JOA and/or related contractual arrangements contain a sublease

When the JO is the sublessee, under IFRS 16, there is no longer any differentiation between operating or finance leases. As a result, there will be a ROU asset and lease liability in relation to the lease with the lead operator, for which each participant in the JO will, in accordance with IFRS 11, need to:

- ▶ Recognise its proportionate share of the ROU asset and lease liability based on its respective interest in the JO
- ▶ During the term of the sublease:
  - ▶ Recognise amortisation of its share of the ROU asset
  - ▶ Recognise interest expense in relation to its share of the lease liability

### 2.5.2 JOA and/or related contractual arrangements does not contain a sublease

Where the JOA and/or related contractual arrangements do not contain a sublease, IFRS 16 does not apply to the JO. Therefore, the non-operator parties will likely continue to recognise amounts payable to the lead operator consistently based on their existing accounting policies.

### 2.5.3 Other factors to consider when evaluating the overall accounting

In addition to the above, there are a number of other potential factors which non-operator parties will need to consider when evaluating the overall accounting, which include but are not limited to:

- ▶ **Capitalisation of costs:** where the activities of the JO are being undertaken in relation to a project that is in the E&E phase or the development phase, depending on the non-operator's accounting policies, it may need to consider whether the costs incurred, e.g., amortisation of the ROU asset and/or interest expense on the lease liability, should be capitalised. Each non-operator party will need to assess whether such costs meet the eligibility requirements for capitalisation in accordance with the relevant standard (including IAS 23), their own policies and appropriate industry practice. If so, the amount that will need to be capitalised versus the amount that will be expensed will need to be identified.
- ▶ **Cash flow impact:** the profile over which ROU amortisation and interest expense will be recognised will vary depending on the nature of the particular asset and could vary significantly from the pattern in which cash costs are incurred. This is because it is expected that most lead operators will seek to align cost recovery with the pattern in which their cash costs are incurred. This is likely to lead to timing and potentially overall measurement differences between amounts incurred and cash outflows recognised.

## 2.6 Other practical considerations

In addition to the issues discussed above, there are other factors requiring consideration which are relevant to both the lead operator and non-operator parties.

### 2.6.1 Access to information

If the contractual arrangement between the lead operator and the JO are concluded to contain a sublease, or the JO itself is considered to have entered into a lease directly with a third party supplier, the parties to the JO will need to recognise their respective share of the lease liability, ROU asset, amortisation expense, interest expense and variable lease payments, if any. To do this, the lead operator will need to provide non-operator parties with the required information. Therefore, parties to the JO will need to discuss and agree what information is required, who will prepare and provide such information and when such information will be made available.

Where lead operators agree to prepare, or are required to prepare, such information on behalf of the non-operator parties, the non-operator parties will need to consider whether there are any material differences in accounting policies which need to be adjusted for before recognising such amounts in their own financial statements. Also, on transition to IFRS 16, it will be necessary to consider the impact of different transition options taken by each of the parties. For example, if the JO exists at transition date and the lead operator prepares this information on a full retrospective basis, but one of the non-operator parties adopts IFRS 16 using the modified retrospective approach, adjustments will be required to align to their transition approach (if material).

### 2.6.2 Impact on systems and processes

Where leases are concluded to exist, this may require significant alterations to systems and processes. Lead operators will be required to consider the ability of existing systems and processes to execute joint interest billing going forward in light of these changes. Non-operator parties will need to consider whether their systems and processes are capable of accounting for leases.

## 3. Next steps

IFRS 16 makes it clear that determining the appropriate accounting treatment in respect of these arrangements will not only require a detailed understanding of the terms and conditions of the JOA and the related contractual arrangements, but will also require an understanding of other relevant facts and circumstances (which may not be embedded in the contracts themselves) as well as the relevant legal environment in each jurisdiction. The appropriate accounting will depend on the specific facts and circumstances and the enforceable rights and obligations of the lead operator and the non-operator parties to the arrangement and may require significant judgement.

Entities are encouraged to liaise closely with parties to each of their JOs, sharing sufficient information so that each member of the JO is able to determine their appropriate accounting.



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