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Financial Reporting Bulletin

Office of the Chief Accountant

Adoption of IFRS 16: Non-GAAP Financial Measures and Reserves Reporting Considerations

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Alberta Securities Commission

Adoption of IFRS 16: Non-GAAP Financial Measures and Reserves Reporting Considerations

1. Purpose

The Office of the Chief Accountant **(OCA)** of the Alberta Securities Commission **(ASC)** has prepared this bulletin to bring attention to two matters that have arisen with respect to International Financial Reporting Standards **(IFRS)** and adoption of IFRS 16 *Leases* **(IFRS 16)** in the context of complying with certain aspects of Alberta's securities laws. The matters involve CSA Staff Notice 52-306 (Revised) *Non-GAAP Financial Measures* **(SN 52-306)** and the requirements of National Instrument 51-101 *Standards of Disclosure for Oil and Gas Activities* **(NI 51-101)** in relation to disclosure of non-GAAP financial measures and implications for reserves reporting.

The objective of this bulletin is to provide helpful and educational information for consideration by reporting issuers and their advisors. Reporting issuers are encouraged to discuss these matters with their advisors.

2. Background on IFRS 16 *Leases*

Effective for financial reporting periods beginning on or after January 1, 2019, reporting issuers that comply with IFRS will adopt a new leasing standard, IFRS 16. This bulletin relates to lease arrangements within the scope of IFRS 16 from the lessee perspective.

A contract contains a lease when the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration[1]. Some examples of oil and gas contracts for which there may be an underlying lease include rental agreements for field trucks, compressors, and storage assets, processing facilities, pipelines and other transportation arrangements, some land access rights, and drilling rig service agreements. Whether these arrangements are in scope of IFRS 16 will depend on the specific facts and circumstances, underlying contract terms, and the applicability of the resource scope exemption[2].

Previously, most leases in the oil and gas industry were classified as operating leases, with lease payments presented in the income statement as operating expenses. Future payments under lease contracts were disclosed in a company's footnotes in the commitments section rather than being recognized on the balance sheet. This led to the view that operating leases are considered off-balance sheet financing.

IFRS 16 requires companies to create a lease liability and recognize a corresponding right-of-use asset for every identified lease, except for certain short-term or low value leases, calculated as the present value of the future fixed lease payments. This right-of-use asset will be depreciated over the economic life of the contract as depreciation expense. The lease liability must be divided between a current and a long-term liability. The amount of this liability will be impacted by the implicit interest on the lease liability and actual cash payments made. Effectively, the operating expense line item recognized under the previous standard will be bifurcated between depreciation expense and interest expense[3]. The timing of expense recognition will be front-loaded as a result of measuring the present value of the lease liability.

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1 IFRS 16 paragraph 9

2 IFRS 16 paragraph 3(a) provides a scope exemption for certain leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources. Reporting issuers are directed to consider recent discussions by the IFRS Discussion Group in January 2019.

3 IFRS 16 paragraph 49

In the statement of cash flows, operating lease payments used to be reflected as an operating activity. Under the new standard, principal payments will be recognized as a financing activity, and interest payments will be recognized as either operating or financing activities depending on the company's existing accounting policy for presentation of finance costs in the cash flow statement[4].

Reporting issuers have the option to either apply IFRS 16 on a full retrospective basis or on a modified retrospective basis. Those that select the full retrospective method will have comparative information that has been restated to reflect adoption. However, under the modified retrospective method, reporting issuers apply IFRS 16 to only the most current period presented in the financial statements without restating prior period comparatives. Disclosure in a reporting issuer's MD&A should clearly describe the option taken and separately describe any impact related to the change in accounting policy.

3. Non-GAAP Financial Measures

The OCA has published two Financial Reporting Bulletins on key performance indicators in the oil and gas industry, which provided guidance on appropriate communication of netbacks, funds flow, and future development costs in the context of IFRS:

- *Disclosure of Key Performance Indicators in the Oil and Gas Industry*, published December 2016; and
- *An update on: Disclosure of Key Performance Indicators in the Oil and Gas Industry*, published January 2018.

These publications discuss our views on appropriate communication of these measures.

Adoption of IFRS 16 will increase depreciation and finance costs associated with the lease obligation; other expenses, such as operating expenses and general and administrative expenses, will decrease. As such, it is expected certain measures will increase including netbacks, cash flow from operating activities, funds flow, EBITDA and EBIT.

SN 52-306 provides regulatory guidance on disclosure of non-GAAP financial measures. In disclosing non-GAAP financial measures, in order to ensure that a non-GAAP financial measure does not mislead investors, a reporting issuer should:[5]

- present the non-GAAP financial measure on a consistent basis from period to period. Inconsistency between terms/labels within documents and between periods may be considered confusing and potentially misleading; and
- clearly articulate why the non-GAAP financial measure provides useful information to investors. One-time use of a measure, or presenting more than one non-GAAP financial measure with a similar purpose may obscure results and may add confusion to the disclosure document.

We would expect reporting issuers to continue to present their non-GAAP financial measures on a consistent basis before and after adoption of IFRS 16. For example, netbacks will still be reduced by a company's operating expense line item within the income statement, regardless of the fact that lease payments will no longer be part of this line item.

We would not expect to see non-GAAP financial measures reflecting the continuation of historic accounting policies, though this information may be beneficial as part of an explanation in the year of adoption.

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4 IFRS 16 paragraph 50, IAS 7 paragraph 33

5 Reporting issuers should refer to SN 52-306 for the full guidance on appropriate disclosure of non-GAAP financial measures.

Netback Example where netback is comprised of sales of petroleum oil and gas less royalties less operating costs, and impact on the year-over-year change is material under both transition methods:

	2018	**2018** *Restated for IFRS 16*	**2019** *IFRS 16*
Netback	$100	$110	$125

If IFRS 16 is adopted using the modified retrospective method:

The netback has increased by $25 between 2019 and 2018. In discussing the reasons for the change, the reporting issuer should differentiate changes due to the adoption of the new standard of $10 from other business related changes of $15. The disclosure of the restated netback for 2018 of $110 would not have to be presented to achieve this.

If IFRS 16 is adopted using the full retrospective method:

The 2019 MD&A would disclose the restated netback for 2018 of $110 and the 2019 netback of $125, a $15 increase. The reporting issuer would discuss the changes in the business that resulted in the $15 increase.

4. Reserves Reporting

Oil and gas evaluations are based on discounted cash flows and incorporate the evaluator's best estimates of future capital and operating costs. The Canadian Oil and Gas Evaluation Handbook Consolidated 3rd Edition (**COGE Handbook**) notes that "the estimate of future operating costs is critical for determining the economic producing life of a property, and capital costs are critical for determining the economic viability of future development, and ultimately for classifying and estimating Reserves".[6]

There will likely be certain costs that are used in the preparation of the reserves estimates which will be impacted by the adoption of IFRS 16. Future operating cost estimates for reserves reporting are derived from historical lease operating statements for each property, which provide detailed information by accounting category. Upon adoption of IFRS 16, costs which have historically been recognized as operating costs within the lease operating statements will now be recognized as depreciation and interest expenses for financial reporting. Reporting issuers will have to re-evaluate how these costs should be accounted for within their lease operating statements considering the ongoing impact on reserves reporting.

In developing an estimate of the operating costs used in an oil and gas evaluation, all active and inactive costs attributed to the property and associated with the operation and maintenance of production are included[7]. The COGE Handbook notes that in preparing operating cost information, cost information may not always be calculated directly from the lease operating statements, and certain costs that should be included in a forecast may be capitalized on the balance sheet. As such, best estimates of future capital and operating costs would continue to include forecasted expenditures on leased assets associated with oil and gas properties. It will be important for evaluators to review the treatment of these costs in the oil and gas economic evaluation of reserves and resources.

6 COGEH, 3.6.1 Capital and Operating Costs pg. 203

7 COGEH, 3.6.1.2 Operating Cost Estimates, pg. 204

5. Future Changes to Alberta's Securities Laws

On September 6, 2018, the Canadian Securities Administrators **(CSA)** published Proposed National Instrument 52-112 *Non-GAAP and Other Financial Measures Disclosures* and Proposed Companion Policy 52-112 *Non-GAAP and Other Financial Measures Disclosures* (collectively, the **Proposed NI 52-112 Materials**). The Proposed NI 52-112 Materials establish disclosure requirements that must be met to disclose non-GAAP financial measures and other financial measures, and are intended to replace SN 52-306.

The 90-day comment period expired on December 5, 2018. The CSA staff responsible for the Proposed NI 52-112 Materials are reviewing the comment letters and are considering the issues raised. Reporting issuers and their advisors are encouraged to monitor the developments.

6. OCA Consultations

Please refer any questions you may have to:

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The OCA is a principal advisor within the ASC, and is a centre of excellence for accounting, auditing and financial reporting knowledge. We use this expertise to serve the broader goals of capital market efficiency and investor protection.

As part of its on-going efforts to promote high quality financial reporting, the OCA communicates with reporting issuers and their advisors by providing consultations, in advance of filing financial statements with the ASC, on unusual or complex technical accounting issues and on financial statement disclosure. Our expectation is that reporting issuers will have consulted with their advisors and have a proposed approach prior to conferring with us.

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