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Appendix: Lessee accounting example

What you need to know

- The IASB has issued a new leases standard that requires lessees to recognise most leases on their balance sheets. For oilfield services lessees, this means recognising assets and liabilities for most leases of construction equipment and office space that they may currently account for as operating leases.

- Lessees will apply a single accounting model for all leases (with certain exemptions).

- Lessor accounting is substantially unchanged and the IAS 17 classification principle has been carried over to IFRS 16.

- The new standard is effective for annual periods beginning on or after 1 January 2019, with limited early application permitted.
Overview

Oilfield services (OFS) entities that provide engineering, procurement, construction and commissioning (EPCC) services will need to change certain lease accounting practices when implementing IFRS 16 Leases, the new leases standard issued by the International Accounting Standards Board (IASB). IFRS 16 significantly changes the accounting for leases by lessees and could have far-reaching implications for OFS entities’ finances and operations. For example, IFRS 16 may require OFS entities to recognise assets and liabilities for leases of construction equipment, and for storage, warehousing and office space they currently account for as operating leases.

IFRS 16 requires lessees to recognise most leases on their balance sheets as lease liabilities with corresponding right-of-use assets. Lessees apply a single model for most leases. Generally, the profit or loss recognition pattern will change as interest and depreciation expense is recognised separately in the statement of profit or loss (similar to today’s finance lease accounting). However, lessees can make accounting policy elections to apply accounting similar to operating lease accounting under IAS 17 Leases to ‘short-term’ leases and leases of ‘low-value’ assets.

Lessor accounting is substantially unchanged from current accounting. As with IAS 17, IFRS 16 requires lessors to classify their leases into two types: finance and operating leases. Lease classification determines how and when a lessor recognises lease revenue and what assets a lessor records. The profit or loss recognition pattern for lessors is not expected to change.

Implementing the standard could also require an entity to develop new processes and controls to track and account for leases, including: (1) identifying a lease; (2) initially and subsequently measuring lease-related assets and liabilities; (3) identifying and allocating consideration to lease and non-lease components; and (4) collecting and aggregating the information necessary for disclosure.

In addition, because the current accounting for operating leases and service contracts is similar, entities may not have always focused on determining whether an arrangement is a lease or a service contract. Some entities may need to revisit assessments made under IAS 17 and IFRIC 4 Determining whether an Arrangement contains a Lease, because under IFRS 16, most leases are recognised on lessees’ balance sheets, and the effects of treating an arrangement as a service instead of as an arrangement containing a lease may be material.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019. Early application is permitted provided that the new revenue standard, IFRS 15 Revenue from Contracts with Customers, has been or is applied at the same date as IFRS 16. Lessees must apply IFRS 16 using either a full retrospective or a modified retrospective approach.

This publication highlights key considerations for OFS entities that provide EPCC services for infrastructure and construction projects in the OFS sector. Like all other entities, OFS entities will also need to apply the new standard to leases of office space, office equipment and all other assets within the scope of IFRS 16.
Our publication, *Applying IFRS, A closer look at the IASB's new leases standard* (EYG no. 02173-163Gbl), issued in August 2016, provides an in-depth discussion of IFRS 16. Please refer to that publication for further information about the technical accounting topics and concepts discussed here. In addition, our *IFRS Practical Matters, Leases make their way onto the balance sheet: Navigating the journey for a smooth landing* (EYG No. AU3725), is designed to help entities understand the business impacts of the new standard. Refer to that publication for further information on the impacts of the standard and the steps entities need to take to apply it.

The views we express in this publication are preliminary as of December 2016. We may identify additional issues as we analyse IFRS 16 and entities begin to interpret it, and our views may evolve during that process.

1. **Key considerations**

1.1 **Scope and scope exclusions**

IFRS 16 applies to leases of all assets, except for the following:

- Leases to explore for or use non-regenerative resources
- Leases of biological assets held by a lessee
- Service concession arrangements
- Licences of intellectual property granted by a lessor
- Rights held by a lessee under certain licensing agreements (e.g., motion picture films, patents and copyrights)

A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets other than those described above.

1.2 **Definition of a lease**

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. To be a lease, a contract must convey the right to control the use of an identified asset.

1.2.1 **Identified asset**

The concept of an identified asset is generally consistent with the ‘specified asset’ concept in IFRIC 4. Under IFRS 16, an identified asset can be either implicitly or explicitly specified in a contract and can be a physically distinct portion of a larger asset (e.g., a floor of a building). Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use.

A substitution right is substantive if the supplier has the practical ability to substitute alternative assets throughout the period of use and the supplier would benefit economically from exercising its right to substitute the asset. For example, the supplier’s substitution rights may not be substantive if: (1) alternative assets are not readily available to the supplier or they could not be sourced by the supplier within a reasonable period of time and hence there is no practical ability to substitute them; or (2) the asset is highly customised and/or significant costs have been incurred to ensure the asset meets the specifications required by the contract such that the supplier would not benefit economically from exercising its substitution right.
If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer presumes that any substitution right is not substantive.

OFS entities enter into a variety of arrangements that will need to be evaluated to determine whether they involve the use of an identified asset, and, whether there is a substantive right of substitution. For example, a contract with a crane subcontractor may specify the exact crane to be used in the provision of the services, identified in the contract by an asset serial number. Alternatively, the contract may provide for the provision of a crane, with specific requirements, but not a specific asset, set out in the contract. Whether, in each circumstance, there is an identified asset will depend on whether an asset is explicitly or implicitly specified in the contract and whether rights of substitution, if any, are considered substantive.

**How we see it**

Even if lease agreements of equipment contain substitution rights, it may be difficult for OFS lessees to readily determine whether the supplier has the practical ability to substitute alternative assets and would economically benefit from exercising that right. Therefore, the substitution right may have to be considered non-substantive.

1.2.2 **Right to control the use of the identified asset**

A contract conveys the right to control the use of an identified asset for a period of time if, throughout the period of use, the customer has both of the following:

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

A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the asset). Economic benefits include the asset's primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits that are generated through its use), including potential cash flows derived from these items. Economic benefits also include those from using the asset that could be realised from a commercial transaction with a third party (e.g., subleasing the asset). However, economic benefits arising from ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset.

A customer has the right to direct the use of an identified asset throughout the period of use when either:

(a) The customer has the right to direct how and for what purpose the asset is used throughout the period of use

Or

(b) The relevant decisions about how and for what purpose the asset is used are predetermined and the customer either:

   i. Has the right to operate the asset, or 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 the operating instructions

   Or
ii. Has 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

When evaluating whether a customer has the right to direct how, and for what purpose, the asset is used throughout the period of use, the focus is on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract. The standard also requires that if the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

IFRS 16 provides examples of the decision-making rights that, depending on the circumstances, may provide the customer with the right to direct how and for what purpose the asset is used, within the defined scope of the customer’s right of use. Examples include: (1) the right to change the type of output produced by the asset; (2) when the output is produced; (3) where the output is produced; and (4) whether the output is produced and the quantity of the output.

Evaluating whether the customer controls the use of an identified asset will be straightforward in most arrangements. However, evaluating other arrangements will require more judgement. In certain types of contracts, both the customer and the supplier may have some involvement in deciding how and for what purpose the asset is used. Therefore, the determination of which party directs the use of the identified asset may require judgement.

For example, in a crewed crane supply contract, the OFS entity (i.e., customer) may have the right to direct when, where and how the crane is used at the construction site, and have the ability to change those decisions. The supplier of the crane may have the right to determine whether conditions are safe for operation. The supplier’s right would be considered a protective right, which, in isolation, is not a decision that most significantly affects the economic benefits derived from the crane throughout the period of use. Therefore, the OFS entity may have the right to direct the use of the identified asset.

1.2.3 Determining whether a contract contains a lease: illustrative examples:

The following example relates to a lease for a pipe-laying barge:

<table>
<thead>
<tr>
<th>Illustrative example 1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pipe-laying barge</strong></td>
</tr>
<tr>
<td>Contractor enters into a subcontract with Barge Co (Supplier) to exclusively use an explicitly specified pipe-laying barge for a three-year period for the purpose of laying a subsea gas pipeline.</td>
</tr>
<tr>
<td>Barge Co does not have substantive substitution rights. Barge Co provides an operator and crew to operate the barge, but it is at the Contractor’s discretion to decide how the barge will be used (what it will move and when). However, Barge Co prohibits certain uses of the pipe-laying barge (e.g., using it unsafely) and modifications to the barge to protect its interest in the asset.</td>
</tr>
</tbody>
</table>
Illustrative example 1 cont’d

Analysis
The subcontract contains a lease for the pipe-laying barge. Supplier has the right to use the barge for three years.

The barge is an identified asset because it is specified in the contract and the supplier does not have a substantive substitute right.

Contractor has the right to control the use of the barge throughout the three-year period of use because:

(a) Contractor has the right to obtain substantially all of the economic benefits from use of the barge over the three-year period of use. Contractor has exclusive use of the barge throughout the period of use.

(b) Contractor has the right to direct the use of the barge. Within the scope of its right of use defined in the contract, Contractor makes the relevant decisions about how and for what purpose the barge is used by being able to decide, for example, where and when the barge will work and how much pipe will be laid on a daily basis. Contractor has the right to change these decisions during the three-year period of use.

Although Supplier can prohibit certain uses and modifications, such as using the barge in an unsafe way. Supplier’s decisions in this regard do not give it the right to direct how and for what purpose the barge is used. These ‘protective rights’ exist in order to protect Supplier’s interest in the barge.

Consequently, Contractor controls the use of the barge during the period of use and Supplier’s decisions do not affect Contractor’s control.

The following example considers a pipe modules fabrication contract:

Illustrative example 2

Contract for fabrication of pipe modules for construction of a subsea gas pipeline

Contractor enters into a contract with a fabrication yard (Supplier) to purchase a particular type, quality and quantity of pipe modules, which will be fabricated over a three-year period and used to construct a subsea gas pipeline. The type, quality and quantity of pipe modules are specified in the contract.

Supplier has only one fabrication yard that can meet the needs of Contractor. Supplier is unable to supply the pipe modules from another fabrication yard or source the pipe modules from a third party supplier. The capacity of the fabrication yard exceeds the output for which Contractor has contracted (i.e., Contractor has not contracted for substantially all of the capacity of the fabrication yard).

Supplier makes all decisions about the operations of the fabrication yard, including the production level at which to run the fabrication yard and which customer contracts to fulfil with the output of the fabrication yard that is not used to fulfil Contractor’s contract.
Illustrative example 2 cont’d

Analysis
The contract does not contain a lease.

The fabrication yard is an identified asset. The fabrication yard is implicitly specified because Supplier can fulfil the contract only through the use of this asset.

Contractor does not control the use of the fabrication yard because it does not have the right to obtain substantially all of the economic benefits from use of the fabrication yard. This is because Supplier could decide to use the fabrication yard to fulfil other contracts during the period of use.

Contractor also does not control the use of the fabrication yard because it does not have the right to direct how and for what purpose the fabrication yard is used during the three-year period of use. Contractor’s rights are limited to specifying output from the fabrication yard in the contract with Supplier. Contractor has the same rights regarding the use of the fabrication yard as other customers purchasing pipe modules from the fabrication yard. Supplier has the right to direct the use of the fabrication yard because Supplier can decide how, and for what purpose, the fabrication yard is used (i.e., Supplier has the right to decide the production level at which to run the fabrication yard and which customer contracts to fulfil with the output produced).

Either the fact that Contractor does not have the right to obtain substantially all of the economic benefits from use of the fabrication yard, or that Contractor does not have the right to direct the use of the fabrication yard, would be sufficient in isolation to conclude that Contractor does not control the use of the fabrication yard.

1.2.4 Transition relief
IFRS 16’s transition requirements are discussed in detail in our publication, Applying IFRS, A closer look at the IASB’s new leases standard (EYG no. 02173-163Gb). Among other transition relief provided, lessees and lessors will be permitted to make an accounting policy election upon initial application of IFRS 16, not to reassess whether contracts are, or contain, leases, provided the requirements of IFRIC 4 have been properly applied. That means that, at the date of initial application of IFRS 16, an entity may elect to apply its current assessment under IFRIC 4 of whether or not its contracts are, or contain, leases.

1.3 Identifying and separating components of a contract and allocating contract consideration
For contracts that contain the rights to use multiple assets (e.g., a building and equipment, multiple pieces of equipment), the right to use each asset is considered a separate lease component if both of the following conditions are met: (1) the lessee can benefit from the use of the underlying asset either on its own or together with other resources that are readily available to the lessee; and (2) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

<table>
<thead>
<tr>
<th>Illustrative example 2 cont’d</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Analysis</strong></td>
</tr>
<tr>
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</tr>
<tr>
<td>Either the fact that Contractor does not have the right to obtain substantially all of the economic benefits from use of the fabrication yard, or that Contractor does not have the right to direct the use of the fabrication yard, would be sufficient in isolation to conclude that Contractor does not control the use of the fabrication yard.</td>
</tr>
</tbody>
</table>

Judgement may be required to identify lease and non-lease components.
Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). For example, rental contracts for a use of a crane may include operation services for the crane. For these contracts, the non-lease components are identified and accounted for separately from the lease component, in accordance with other standards. For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to IFRS 15 by lessors (suppliers).

IFRS 16 provides a practical expedient that permits lessees to make an accounting policy election, by class of underlying asset, to account for each separate lease component of a contract and any associated non-lease components as a single lease component. Lessees that do not make an accounting policy election to use this practical expedient are required to allocate the consideration in the contract to the lease and non-lease components on a relative stand-alone price basis. Lessees are required to use observable stand-alone prices (i.e., prices at which a customer would purchase a component of a contract separately) when available. If observable stand-alone prices are not readily available, lessees estimate stand-alone prices, maximising the use of observable information.

How we see it

Identifying non-lease components of contracts (e.g., maintenance services for construction equipment or service contracts) may change practice for some lessees in the OFS industry. Today, entities may not focus on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for an operating lease and a service contract) is often the same. However, because most leases are recognised on lessees’ balance sheets under IFRS 16, lessees may need to put more robust processes in place to identify the lease and non-lease components of contracts.

2. Lease classification

Under IFRS 16, lessees apply a single accounting model for all leases, with options not to recognise short-term leases and leases of low-value assets on the balance sheet. See sections 3.1 Short-term leases recognition exemption and 3.2 Leases of low-value assets recognition exemption for more detail.

Lessor, however, classify all leases in the same manner as under IAS 17, distinguishing between two types of leases: finance and operating. Lessors are required to reassess lease classification upon a modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of its original terms and conditions) that does not result in a separate lease.

3. Lessee accounting

At the commencement date of a lease, a lessee recognises a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset).

Lessees measure the lease liability using the interest rate implicit in the lease, if that rate is readily determinable. If that rate cannot be readily determined, the lessee is required to use its incremental borrowing rate. Lessees measure the right-of-use asset at the amount of the lease liability, adjusted for lease incentives affect the initial measurement of lease assets and liabilities.
prepayments, lease incentives received, the lessee’s initial direct costs (e.g., commissions) and an estimate of restoration, removal and dismantling costs.

Lessees are required to separately recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset. When the right-of-use asset is depreciated on a straight-line basis, this will generally result in a front-loaded expense recognition pattern, which is consistent with the subsequent measurement of finance leases under IAS 17.

Appendix A sets out an example of lessee accounting.

3.1 Short-term leases recognition exemption

Lessees can make an accounting policy election, by class of underlying asset to which the right of use relates, to apply accounting similar to IAS 17’s operating lease accounting to leases that, at the commencement date, have a lease term of 12 months or less and do not include an option to purchase the underlying asset (short-term leases). If a lessee applies this exemption, short-term leases are not recognised on the balance sheet and the related lease expense is recognised on a straight-line basis over the term of the lease or another systematic basis, if that basis is more representative of the pattern of the lessee’s benefit.

3.2 Leases of low-value assets recognition exemption

Lessees can also make an election, on a lease-by-lease basis, to apply accounting similar to current operating lease accounting to leases for which the underlying asset is of low value (low-value assets). To be a low-value asset, a lessee must be able to benefit from the asset on its own or together with other resources that are readily available to the lessee. In addition, a low-value asset must not be highly dependent on, or highly interrelated with, other assets. At the time of reaching its decision about the exemption, the IASB had in mind leases of underlying assets with a value, when new, of US$5,000 or less.

4. Lessor accounting

Entities in the OFS industry that provide EPCC services typically are not lessors unless they sub-lease an asset they have leased from another entity. For a discussion of lessor and sub-lessee accounting, refer to our publication, Applying IFRS, A closer look at the IASB’s new leases standard (EYG no. 02173-163Gbl).

5. Other considerations

5.1 Sale and leaseback transactions

IFRS 16 requires lessees to recognise most leases on the balance sheet (i.e., all leases except for short-term leases and leases of low-value assets if the lessee makes accounting policy elections to use those exemptions). As such, sale and leaseback transactions will no longer provide lessees with a source of off-balance sheet financing.

IFRS 16 requires seller-lessees and buyer-lessees to apply the requirements in IFRS 15 to determine whether a sale and purchase has occurred in a sale and leaseback transaction. If control of an underlying asset passes to the buyer-lessee, the transaction is accounted for as a sale (or purchase) and a lease by both parties. If not, the transaction is accounted for as a financing by both parties.
How we see it

The new requirements are a significant change from current practice for seller-lessees. Under IFRS 16, seller-lessees must apply the requirements in IFRS 15 to determine whether a sale has occurred. Also, even if the criteria for a sale have been met, sale and leaseback transactions, generally, would no longer lead to an off-balance sheet financing.

Next steps

- OFS entities should evaluate as soon as possible how the new leases standard will affect their internal controls and information systems. Two critical first steps include: (1) identifying the sources and locations of an entity’s lease data; and (2) accumulating the data in a way that will facilitate the application of IFRS 16. For entities with decentralised operations (e.g., an entity that is geographically dispersed), this could be a complex process, given the possibility for differences in operational, economic and legal environments.

- A review of all contracts that may include lease components that have not been identified before the application of IFRS 16 is also relevant.

- OFS entities will need to make sure they have the processes, including internal controls and systems, in place to collect the necessary information to implement IFRS 16 (including making the relevant financial statement disclosures).

- OFS companies need to make a preliminary assessment of how the new standard affects their balance sheets and prospective income statements as well as the disclosure notes to the financial statements.

- OFS companies may wish to consider revisions to contract terms in light of the implications of the new leases standard.

- OFS entities should consider how they might communicate changes to their financial reporting to investors and other stakeholders.
Appendix A: Lessee accounting example

**Illustration – Lessee accounting**

Contractor D (Lessee) enters into a three-year lease of an excavator to clear the land for construction of an onshore gas pipeline. Contractor D agrees to make the following annual payments at the end of each year: CU10,000 in year one, CU12,000 in year two and CU14,000 in year three. For simplicity, there are no purchase options, payments to the lessor before the commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is CU33,000 (present value of lease payments using a discount rate of 4.235%). Contractor D uses its incremental borrowing rate as the discount rate because the rate implicit in the lease cannot be readily determined. Contractor D depreciates the right-of-use asset on a straight-line basis over the lease term.

**Analysis:** At lease commencement, Contractor D recognises the right-of-use asset and lease liability in a manner similar to a finance lease today:

<table>
<thead>
<tr>
<th>Right-of-use asset</th>
<th>CU33,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>CU33,000</td>
</tr>
</tbody>
</table>

To initially recognise the lease-related asset and liability

The following journal entries would be recorded in the first year:

<table>
<thead>
<tr>
<th>Interest expense</th>
<th>CU1,398</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>CU1,398</td>
</tr>
</tbody>
</table>

To record interest expense and accrete the lease liability using the interest method (CU33,000 x 4.235%)

| Depreciation expense   | CU11,000 |
| Right-of-use asset     | CU11,000 |

To record depreciation expense on the right-of-use asset (CU33,000 ÷ 3 years)

| Lease liability        | CU10,000 |
| Cash                   | CU10,000 |

To record lease payment

A summary of the lease contract’s accounting (assuming no changes due to reassessment) is as follows:

<table>
<thead>
<tr>
<th>Initial</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lease payments</td>
<td>CU10,000</td>
<td>CU12,000</td>
<td>CU14,000</td>
</tr>
<tr>
<td>Lease expense recognised</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>CU1,398</td>
<td>CU1,033</td>
<td>CU569</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>11,000</td>
<td>11,000</td>
<td>11,000</td>
</tr>
<tr>
<td>Total periodic expense</td>
<td>CU12,398</td>
<td>CU12,033</td>
<td>CU11,569</td>
</tr>
</tbody>
</table>

**Balance sheet**

| Right-of-use asset | CU33,000 | CU22,000 | CU11,000 | CU– |
| Lease liability    | CU(33,000) | CU(24,398) | CU(13,431) | CU– |

Immaterial differences may arise in the re-computation of amounts in the example above due to rounding.
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