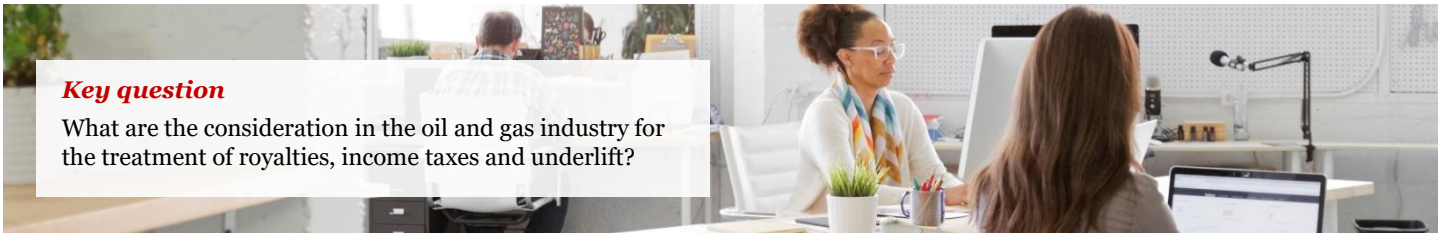
A walk in the park:

IFRS 15 implementation efforts of 2018 interim reporters in the oil and gas industry

Introduction

IFRS 15 [Revenue from contracts with customers] became effective 1 January 2018 and is already being implemented in the 2018 interim reports of IFRS reporters. For many in the oil and gas industry, the implementation of IFRS 15 was expected to be a walk in the park. This expectation was hinged on the simplicity around the sale of the products and the ease in determining the sales price [market prices are readily available]. However in reality, oil companies have found implementation to have some complexities. Particularly, there are questions being raised around the treatment of royalties, income taxes and underlifts. Especially due to the fact that their treatment vary across jurisdiction and across oil and gas arrangements. The key questions that will be addressed in this article is shown below.



Key question

What are the consideration in the oil and gas industry for the treatment of royalties, income taxes and underlift?

Overview

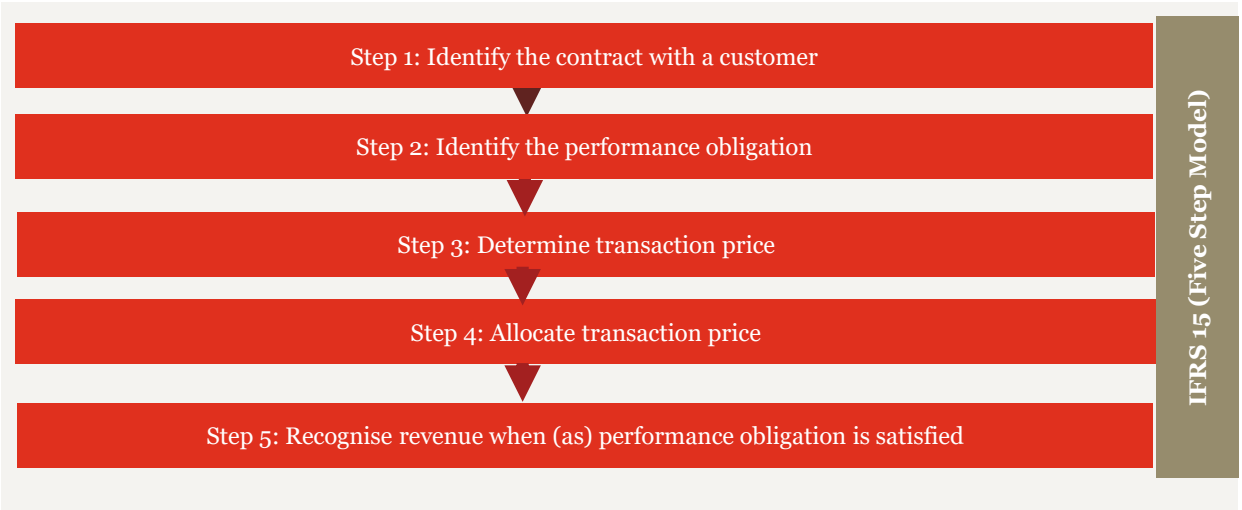
Oil Companies wishing to explore in an oil producing country negotiate for oil licenses which give them the right to drill for oil. In return for drilling, royalties and income taxes are paid to the government in cash or in kind i.e. through oil lifting. Where settled in kind it is referred to as royalty oil and tax oil.

It is also common for the government to partner with oil companies to explore for oil. When this happens, the oil companies and the government usually agree to share production based on a lifting schedule; for instance Oil Company A, Oil Company B and the Government agree a sharing ratio of 20:30:50. There are times when a partner lifts less [or more] than its share of production. When this happens there would be an underlift and [vice versa – it would be called an overlift].

This article will focus on the accounting treatment of royalty oil, tax oil and underlift which, prior to the adoption of IFRS 15, may have been included or excluded from revenue. While this is a high level analysis, it is important to note that the statutory and contractual terms for royalty oil, tax oil and underlifts may vary across jurisdictions and contracts, so it is necessary to understand the terms of each arrangement to assess the specific impacts.

Overview of IFRS 15 Revenue from contracts with customers

The core principle of this standard is that it requires revenue be recognised to depict the transfer of goods or services to customers for consideration. It provides a five step revenue recognition model [as shown below] as a guide for all entities in all industries.



This article focuses on the first step where companies determine if a contract with a customer exists and if the contract is within the scope of the standard. Revenue from transactions or events that do not arise from a contract with a customer is not in the scope of the revenue standard and should be recognised in accordance with other relevant standards. Furthermore, the revenue standard specifically excludes from its scope non-monetary exchanges between entities in the same line of business to facilitate sales to current or future customers.

The scope includes transactions with collaborators or partners if the collaborator or partner obtains goods or services that are the output of the entity's ordinary services. It excludes transactions where the parties are participating in an activity together and share the risks and benefits of that activity.

In defining a customer, the standard provides that a customer is another party that, purchases an entities goods and services in exchange for consideration, and does not share in the risk and reward of the business. Consideration could be cash or non-cash.

In a collaborative arrangement [which is the norm in the oil and gas industry] the substance of the transaction entered into by the partners [parties] is paramount when identifying if a portion or all of the contract is with a customer. This is because there are instances where a portion of the contract might be within the scope [sale of goods or services] and another potion maybe out of scope [sharing of risk and benefits of the business] of the standard.

Another factor to look at when identifying a customer is the relationship between the parties; the substance of their relationship is key. Where another party is involved in providing goods or services to a customer it is necessary to assess if the party is providing these goods and services as a principal (that is, the nature of its promise is a performance obligation to provide the specified goods or services itself) or as an agent (that is, the nature of its promise is to arrange for the other party to provide those goods or services).

This assessment is necessary especially in the oil and gas industry because oil and gas partners may act as principals or agents when lifting oil during their operations. An entity is a principal when control over the goods and services passes to it, IFRS 15 provides clearer guidance that supplements the control requirement when deciding on whether an entity is a principal or agent.

Companies should consider the following additional indicators in order to determine who a principal is.

S/N	Indicators that an entity is a principal include the following:
1	the entity is primarily responsible for fulfilling the promise to provide the specified good or service;
2	the entity has inventory risk be fore the specified good or service has been transferred to a customer, or after transferring the control to the customer
3	the entity has discretion in establishing the prices for the specified goods or services.

Implementation of IFRS 15

Royalties

In a bid to retain some form of working interest, governments of oil producing countries levy royalties on oil companies. It is usually determined as a percentage of oil production and is paid to the government authority. Sometimes the government negotiates to lift oil directly from the oil wells/storage tanks [non-monetary] rather than conventionally receiving cash [monetary].

In determining how to treat royalties, it is important to first assess it based on IAS 12 Income taxes to determine if it is a tax expense. This is because, depending on the jurisdiction and on its basis, it may fall within scope of IAS 12. IAS 12 provides guidance on taxes calculated based on taxable profits. Royalties should be treated in accordance with this standard if in a particular jurisdiction it is determined based on taxable profits – ['Taxable profit' implies a net rather than a gross taxable amount] - this is uncommon. If royalties are taken directly from reserves as a percentage of production [production entitlement of the government] they are scoped out of IAS 12 as it is based in a gross measure. In this instance, royalties are not considered tax expenses, but are rather accounted for as other expenses [royalty expenses].

Whereas IAS 12 gives guidance on the treatment of the expense related to these payments to government, we look to IFRS 15 to determine if the credit/income should be recognized in revenue or otherwise. Prior to the adoption of IFRS 15, some companies recognized the oil lifted by the government in revenue. Others deducted it from inventory. In both instances, royalty expenses were recognized.

Under IFRS 15, it is critical to properly assess each contract in each jurisdiction to determine the appropriate treatment. In most jurisdictions, royalties are in effect the government's share in the natural resources exploited (their production entitlement) and may be paid in cash or kind. If paid in cash, it is necessary to assess if the company is acting as a principal or an agent i.e. if it has control over the goods based on the three indicators earlier highlighted in the principal/agency consideration.

If the Oil Company is the principal, then on sales to the third party it recognizes a credit as revenue from contracts with customers and a debit as cash received. Eventually, It recognises the cash payment to the government as other [royalty] expenses [if the expense is out of scope of IAS 12 as discussed above]. On the other hand, where the Oil Company is acting as an agent i.e. control over the oil does not pass to it, royalty payments should be excluded from revenue and costs.

Where the government lifts directly its production entitlement and sells to its customers, the agent and principal consideration may be less paramount since it is unlikely that the government would be an agent lifting its entitlement, in the rare instance that it is, then the Oil Company may recognise revenue from contract with customers in accordance with the standard and royalty expenses when the oil is sold to a customer. Otherwise, the government is a principal and the Oil Company should not include the royalty oil in its revenue or costs.

As can be seen, to determine the appropriate treatment for royalties, a critical review of the statutes of the jurisdiction and/or contract is required to identify the applicable scenario.

Income taxes

Oil companies are also required to pay income taxes determined based on taxable profit –which are within the Scope of IAS 12. Taxable profits are arrived at after revenue has been earned, expenses deducted and profit determined. In some jurisdictions/contracts the taxes may be payable in cash, however like royalties, the government may agree with an oil company to lift oil in lieu of cash payments. Tax oil lifted would be based on tax payable to the government. The government would sell the oil and use the proceeds to settle the tax liability of the oil company. Where the Oil Company lifts oil and pays taxes in cash as with other industries, the treatment is straight forward, tax liability initially recognised is reduced. As with royalties a dilemma arises where the government instead lifts tax oil. Should the oil lifted in lieu of cash payments be included first in revenue or elsewhere by the oil company? Should the oil lifted be excluded totally from the books of the oil company since it is lifted directly? Prior to IFRS 15, some companies recognized tax oil in revenue or as a deduction from inventory with a corresponding entry in tax expenses.

In considering the appropriate treatment under IFRS 15, the guidance establishing if a contract with a customer exist should be considered. If the tax oil is within scope of IAS 12, then it means the Company has an obligation to the government for which it settles in cash or kind (if the government lifts tax oil directly). Where the government lifts tax oil, it is necessary to assess if the government is lifting the oil as a customer in settlement of the company's obligation to it. In such instances, the tax oil may still be recognised as revenue from contracts with customers as the scope of IFRS 15 includes transactions with collaborators or partners if the collaborator or partner obtains goods or services that are the output of the entity's ordinary activities. A proper assessment of each specific scenario considering the statutes and contractual terms is required in coming to this conclusion.

Underlift

Under IFRS 15 the definition of a customer may exclude parties in a collaborative arrangement. Whether underlift and overlift transactions fall within the scope of IFRS 15 would be judgmental and would require considering all facts and circumstances including the purpose of the arrangement and transactions.

An overlifter may be a customer but would not be within the scope of IFRS 15 where the transaction is a non-monetary exchange between entities in the same line of business. This might result in a divergence from current accounting treatment.

Underlift occurs where a Partner lifts less than its share of production. As a result, a liability arises from the overlifter who lifts more than its share and then settles in cash or via future lifting - which is more common. Prior to IFRS 15, underlifts were usually recognized in revenue with a corresponding entry in receivables or inventory.

This transaction will be within the scope of IFRS 15 where:

- the overlifter meets the definition of a customer in the standard; and
- the transaction is not a non-monetary exchange between entities in the same line of business.

If either one of the criteria above is not met the transaction is out of scope of the standard. This would mean that the underlifter would not recognise revenue from a contract with a customer until its future lifting were sold to a third party customer in another period.

The underlifter might still recognise a receivable in the scope of IFRS 9, at the time of lifting even when the transaction is outside the scope of the new standard, which would be settled subsequently.

Management would need to determine where in the income statement to recognise the credit, this could be recognized as other revenue or other income.

If the transaction is out of scope of IFRS 15, the accounting should be based on other guidance, such as IAS 16 Property, plant and equipment if the transaction is a non-monetary exchange.

Oil companies should use judgement in selecting an accounting policy that is relevant and reliable to their circumstance.

PwC – helping to solve important problems that arise during implementation of new IFRS standards

Despite the clear and detailed principles provided in IFRS 15. Challenges may ensue when applying these principles, this is mostly due to the peculiarities that exists in divergent arrangements, industries and jurisdictions. PwC is hands on in addressing these peculiarities as they arise. We are involved in supporting clients all over the world to ensure a smooth transition when implementing new IFRS standards.

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