

The new revenue recognition standard – oil and gas

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What you need to know

- ▶ The application of IFRS 15 will require entities to use a greater degree of judgement to meet its requirements.
- ▶ The key issues for oil and gas entities include:
 - ▶ Identifying whether a contract is within the scope of the new standard
 - ▶ Evaluating performance obligations in contracts
 - ▶ Accounting for production imbalances
 - ▶ Evaluating fixed and provisionally priced arrangements.
- ▶ Oil and gas entities may have to change their processes and information systems to capture information they will need to apply the standard and make the required disclosures.
- ▶ The standard is applicable for annual reporting periods commencing on or after 1 January 2017, with early adoption permitted.

Highlights

Oil and gas entities may need to change certain revenue recognition practices as a result of IFRS 15 *Revenue from Contracts with Customers*, the new revenue recognition standard that was jointly issued by the International Accounting Standards Board (the IASB) and the Financial Accounting Standards Board (the FASB) (collectively, the Boards). The standard will supersede virtually all revenue recognition requirements in IFRS and US GAAP.

IFRS 15 provides accounting requirements for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other IFRS requirements, such as IAS 17 *Leases*). The standard also provides a model for the measurement and recognition of gains and losses on the sale of certain non-financial assets, such as property, plant and equipment (PP&E).



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Our *Applying IFRS: A closer look at the new revenue recognition standard*¹ provides an in-depth discussion of IFRS 15, whereas this publication summarises the key implications of the standard for oil and gas entities.

Oil and gas entities may want to monitor the discussions of the Boards' Joint Transition Resource Group for Revenue Recognition (TRG). The TRG was created to help the Boards determine whether more implementation guidance is needed. The TRG will not make formal recommendations to the Boards or issue guidance. Separately, the American Institute of Certified Public Accountants (AICPA) has established 16 industry task forces, including one for the oil and gas industry, to help develop a new accounting guide on revenue recognition and to aid industry stakeholders in implementing the standard. Any views discussed by the TRG or guidance provided by the AICPA will be non-authoritative.

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

Key considerations

To apply IFRS 15, oil and gas entities will need to change the way they evaluate many of their transactions. In general, we do not expect IFRS 15 to significantly affect the revenue recognition profiles and practices for many types of arrangements that are common to oil and gas entities. However, they will still need to carefully evaluate how it may affect specific contracts in upstream, midstream and downstream, as well as financial reporting processes overall.

Oil and gas entities may need to use significant judgement to evaluate whether contracts fall within the scope of IFRS 15 and determine the individual performance obligations within a contract.

Identifying when to apply IFRS 15

Oil and gas entities must first evaluate whether their contracts are subject to IFRS 15, or if they are within the scope of other IFRSs, such as IAS 17. This assessment could change in the future as a result of the Boards' joint project on leases.

Because arrangements entered into by oil and gas entities are becoming increasingly complex, it may be challenging to determine whether the counterparties to contracts are collaborators or customers. Production sharing contracts, concession agreements, and similar risk sharing contracts could be considered collaborative arrangements and, hence, outside the scope of the standard, which applies only to contracts with customers. However, oil and gas entities may provide these counterparties goods and services that are within the scope of IFRS 15.

Oil and gas entities may dispose of non-financial assets such as PP&E. IFRS 15 consequentially amends other standards, such as IAS 16 *Property, Plant and Equipment*, and will effectively establish a new model for derecognising non-financial assets that applies its concepts, even for sales to non-customers. As a result, the measurement and timing of recognition of gains/losses on sales of these assets may differ from that under current IFRS.

Evaluating performance obligations in long-term supply agreements

Oil and gas entities in upstream, midstream and downstream often enter into contracts with terms based on commodity volumes, such as contracts to sell, transport or process a specified amount of a commodity. Properly identifying the performance obligations in these contracts may be complex, but will be critical because these determinations will drive the pattern of revenue recognition.

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¹ Available on www.ey.com/ifrs

Take-or-pay, capacity reservation and similar contracts often contain complex terms that will require careful analysis for each step of the model.

If an oil and gas entity determines that a fixed-price contract to sell a commodity over multiple periods has multiple performance obligations, it will need to determine the stand-alone selling price of each performance obligation in order to allocate the transaction price and ultimately establish the pattern of revenue recognition. The new standard does not provide specifics for determining the selling price for contracts to sell commodities that involve multiple performance obligations (e.g., use a calculated value, a current market price or a forward price). As a result, additional developments in this area are likely.

Other multi-period contracts may contain escalating or declining rates in different periods (e.g., some take-or-pay, minimum capacity or long-term supply contracts). Entities with these types of contracts should carefully consider the contractual terms and evaluate the reasons for the rate changes when identifying the performance obligations, determining the transaction price, and considering how to allocate the transaction price to the performance obligations.

The conclusions that entities reach may change the pattern of revenue recognised (e.g., on a straight-line basis, following the contractual pricing). In addition, these contracts may contain a significant financing component that entities must account for separately, which may affect the amount of revenue recognised.

Accounting for production imbalances

Production imbalances often arise on oil and gas properties for which two or more owners have the right to take production in kind. Each owner is entitled to its working interest percentage in the property's total production. However, at any given time, the amount of oil or gas actually sold by each owner may differ from its working interest percentage, resulting in production imbalances or over/under-lift.

IFRS does not currently address the accounting for production imbalances. However, entities generally follow either the sales method or the entitlements method to record revenue. The entitlements method results in an adjustment to either revenue or cost of sales for the difference between the working interest and the actual volumes sold. As this adjustment under the entitlements method is between the entity and its joint venture partners, entities will have to consider whether the joint venture partner is a customer, and whether the transaction qualifies as revenue from contracts with customers, or whether it is outside of the scope of IFRS 15.

Fixed and provisionally priced arrangements

Oil and gas entities may find it challenging to estimate the transaction price, particularly when it includes variable consideration. Sales contracts for liquefied natural gas ordinarily include provisional pricing at the time of shipment, with final pricing based on the average market price for a particular period. Linkage to an index is also becoming more prevalent in domestic gas contracts in some jurisdictions. Entities will need to continue to evaluate whether these terms represent embedded derivatives that they must account for separately, as required under current IFRS.

Next steps

Oil and gas entities will need to evaluate the requirements of IFRS 15 and make sure they have processes and systems in place to collect the necessary information to implement the standard. They may also wish to monitor the ongoing discussions of the Boards, the TRG and the AICPA so they can consider the impact of evolving interpretations and application of the new standard to common transactions. Entities also should consider their communication plans with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards that are issued but not yet effective, as required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

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