

Our *Exploring IFRS* series examines current developments in IFRS and relates them specifically to the potential impact that they might have on companies in the oil and gas sector. This issue provides a high-level overview of the potential implications of the new revenue recognition proposals.

Introduction

We issued a publication entitled *Revenue from Contracts with Customers: The road to convergence: what the revenue proposals mean in practice*¹ summarising the revenue recognition model proposed in the joint Exposure Draft (ED) of the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) (together, the Boards). We also highlighted some issues for companies to consider in evaluating the merits of the ED and some of the expected changes to current IFRS.

In this issue of *Exploring IFRS* we look at some of the more significant implications that the proposed revenue recognition model may have for the oil and gas sector. The impact for oilfield services has been considered in a separate publication entitled *Revenue from contracts with customers – impact on the oilfield services sector*.

The issues discussed here are intended to both provoke thought and to assist companies in formulating ongoing feedback to the Boards that can help in the development of a high-quality final standard. Nevertheless, these discussions do not represent final or formal views and additional issues may be identified, as the elements of the ED are subject to change on further deliberation by the Boards before a final standard is issued.

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1. Available on ey.com/ifrs

Scope

Definition of revenue and a customer

Revenue is currently defined in IFRS as:

"Income arising in the course of an entity's ordinary activities."

This definition has been carried forward unchanged in the ED. The Boards noted in the Basis for Conclusions to the ED that they would not revisit the definition of revenue as part of this project but, instead, would do this as part of their joint Conceptual Framework project.

The proposed revenue recognition guidance in the ED then only applies to **revenue from contracts with customers**. That is, it only deals with a subset of an entity's potential revenue generating activities.

The ED defines a customer as:

"... a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities."

Neither current IFRS nor the ED defines "ordinary activities". The Boards indicated in the Basis for Conclusions to the ED that they were not going to clarify the meaning of "ordinary activities" because that notion was derived from existing revenue definitions, which as noted, were not being revisited as part of this project.

How we see it

There are many complex contracts in the oil and gas industry and diversity currently exists in how these are accounted for. By not revisiting the definitions of revenue or ordinary activities, while proposing a model that only deals with a subset of an entity's total revenue generating activities, there is a risk of creating further uncertainty as to what constitutes an entity's ordinary activities and, hence, represents total revenue.

Generally, if a contract was not previously considered to be a customer contract, we do not believe this ED will change this. Having said this, in some cases this may not be clear. Therefore some contracts (e.g., production sharing contracts) may need to be evaluated to determine if they represent customer contracts.

Determining who is a customer will require an assessment of the individual facts and circumstances. Without specific guidance as to what are considered an entity's ordinary activities may mean lead/add to divergent interpretations.

It is our understanding that should a contract or arrangement not fall within the scope of this ED, it does not necessarily preclude the potential inflows from such contracts from being described as part of total revenue (albeit from non-customers).

Other scope exemptions

The proposed revenue recognition guidance states that if a contract is partially within the scope of another standard, then the provisions of that other standard (e.g., accounting for an embedded lease or an embedded derivative) are applied to that specific section of the contract. As such, the scope of the proposed revenue recognition guidance excludes leases, among other contracts.

How we see it

Although the criteria for determining what is or is not a lease will not change under the proposed leasing ED, this assessment will take on increased importance.

The current accounting for operating leases and service contracts is often similar. Therefore, determining that a service arrangement contains an operating lease generally does not result in significantly different accounting. Consequently, it is possible that not all embedded leases have been identified, extracted and/or accounted for as such.

Given the proposed accounting for operating leases in the new lease model will be completely different, this assessment will have significantly different accounting implications where service contracts are considered to contain embedded leases and therefore entities may need to evaluate current and future contracts more closely.

Sales and entitlements methods

Product 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 their working interest percentage in the property's total production. However, at any given time, the amount of oil or gas sold by each owner may differ from their working interest percentage. The discrepancies in the amounts sold and the amounts that the interest owners are entitled to are referred to as production imbalances.

Example 1 – Accounting for imbalances

Company A and Company B each hold a 50% working interest in Field C.

Field C produces 100,000 barrels of oil in the current month. Company A sells 60,000 barrels of oil at \$75/barrel to Refining Company D. So actual sales equate to 60,000 barrels and there is an imbalance of 10,000 barrels.

Current practice

IFRS does not currently address the accounting for these imbalances directly. Oil and gas revenue recognition currently follows variations of one of two currently accepted methods:

a) Sales method

Revenue is recognised based on the actual amounts sold. No receivables or payables are recorded for any imbalance.

b) Entitlements method

Net revenue reflects the participant's share of production regardless of which participant has actually made the sale and invoiced the production. Generally, the imbalance in a particular period will be 'made up' over the life of the field such that at the end of the working interest relationship each party will have sold an amount materially consistent with its entitled volumes.

To account for the imbalance between actual sales and entitlements, one of the following approaches is used:

I. Adjust revenue

The excess of:

- ▶ Product sold during the period over
- ▶ The participant's ownership share of production from the property, is recognised by the overlift party as a liability and not as revenue. Conversely, the underlift party recognises an underlift asset and reports the corresponding revenue. It is our understanding that this method is rare among IFRS preparers.

II. Adjust cost of sales

Cost of sales is adjusted to take account of an asset or liability that reflects the lifting imbalance while revenue is shown at the actual invoiced amount.

Potential impact of new proposals

The proposed revenue recognition model applies to contracts with customers.

The Basis of Conclusions to the ED provides examples of arrangements that should be analysed to determine if a supplier-customer relationship exists or if it is some other type of relationship. A specific example provided is accounting for imbalances between proportionate entitlements and sales volumes.

These are only mentioned as a type of arrangement to be considered - no conclusions are provided. Instead, it simply states that all relevant facts and circumstances need to be considered in assessing whether the counterparty meets the definition of a customer. Given this, the assessment of such arrangements could be open to interpretation and divergence in practice may continue if further guidance is not provided.

a) Sales method

- ▶ The sale of the actual product by the oil and gas company to a third party represents a contract with a customer. Therefore, it is within the scope of the ED (regardless of whether the seller is entitled to the volumes).

b) Entitlements method

The entitlements method could effectively be considered to comprise two components:

- ▶ The actual sale of product to a third party – this would be accounted for the same as the sales method of accounting; and
- ▶ Accounting for the imbalance between the working interest owners - it may be unlikely that this would qualify as a customer contract, as the counterparty may not be considered to be a customer. If this is the case, accounting for the imbalance would generally fall outside the scope of the ED and other IFRSs would have to be considered.

Given this, we consider that the current method of adjusting cost of sales will continue to be available.

Where positive adjustments i.e., underlifts, are currently made against revenue, as noted above, our understanding is that while these are unlikely to be considered within the scope of the ED, this would not necessarily prohibit the amounts receivable from these arrangements from being described as part of total revenue from ordinary activities. Consequently, without specific guidance to the contrary, it is likely that this approach will continue to be available. Having said this, it is unclear whether these adjustments would have to be presented separately from the “revenue from contracts with customers”.

Potentially greater difficulties will arise for the overlift party who would ordinarily reduce revenue by the amount of the imbalance by effectively recognising a debit to total revenue and then recognising a liability. If such an adjustment has to be presented separately from “revenue from contracts with customers”, from a presentation perspective, it is unlikely to be acceptable for a net debit balance to remain in the revenue section. Instead such an adjustment would have to be made elsewhere in profit or loss.

How we see it

We believe the sales method would be within the scope of the ED and therefore current practice is likely to remain unchanged.

In relation to the entitlements method, we believe the actual sale of product to the external customer would fall within scope and would continue to be recognised as revenue when control passes. The accounting for the imbalance would fall outside of scope unless the arrangement represents a customer-supplier relationship. Therefore, other IFRSs would need to be applied.

Given this, we consider that the practice of adjusting cost of goods sold, and of adjusting total revenue for those in underlift positions, will continue to be acceptable – although there may be some minor presentation impacts.

Those parties in overlift positions that currently effectively debit revenue, will be likely to have greater presentation impacts as we do not believe it will be acceptable to present a net debit balance within revenue. As a result, total revenue will be higher than currently presented.

Risk sharing arrangements

In the oil and gas industry entities usually obtain the rights to explore for, develop, and produce oil and gas through mineral leases, concession agreements, production-sharing contracts, or service contracts. Two common examples of these are production sharing contracts/arrangements (PSCs) and risk services contracts.

Production sharing contracts/arrangements (PSCs)

A PSC is a contract between the National Oil Company (NOC) of a host country and a contracting enterprise (the oil and gas company) to carry out oil and gas exploration, development and production activities, or any combination of the three, in accordance with the specific terms of the contract. The oil and gas company generally will be responsible for extracting the NOC's share of production from a field and is typically responsible for 100% of exploration costs and some or all of development and production costs.

Risk services contracts

In a risk service contract (also called risked service agreement or at-risk service contract) an entity (contractor) agrees to explore for, develop, and produce minerals on behalf of a host government, but the contractor is at risk for the amount spent on exploration and development costs.

If production commences, the entity will receive a fee representing its costs plus a profit (the fee is typically capped at a certain price per barrel produced). However, if no minerals are found in commercial quantities, no fee is paid.

This type of contract is different from a pure services contract, which is considered to be a management contract that gives rise to revenue from rendering services and not income from the production of minerals.

Current practice

Currently, there is no specific guidance within IFRS governing the accounting for PSCs or risk services contracts. These contracts are generally considered to be more akin to working interest relationship than pure services contracts. This is because the oil and gas company is assuming risks associated with performing oil and gas producing activities and is either receiving a fee or a share of future production as specified in the contract.

Under current IFRS, revenue is recognised once production commences and upon sale of the oil or gas company's share of the oil or gas to third parties as opposed to being recognised as a fee for services rendered pre-production.

Potential impact of new proposals

In determining whether a contract between a NOC and an oil and gas company is within the scope of the ED, an entity must look to the definition of a customer and what constitutes "ordinary activities", as discussed above.

How we see it

As the Boards appear to have relied on current definitions of revenue and ordinary activities, we believe the relationship between an oil and gas company and a NOC is likely to continue not to represent a customer relationship relating to the provision of services. Therefore, such contracts could be outside the scope of this ED.

Having said this, the terms and conditions of contracts with governments / NOCs continue to evolve, particularly given the percentage of the world's oil and gas reserves that are owned by governments. As such, the facts and circumstances of all arrangements should be carefully assessed to determine whether the relationship between the two parties changes and potentially becomes a supplier-customer relationship and, hence, falls within scope.

Production payments

Entities sometimes seek funding for exploration and development activities and repay the lender with a production payment royalty. There are basically two types of production payments. One type is repayable in cash from the sales proceeds of a specified share of future production of a producing property, until the amount advanced plus interest at a specified or determinable rate is paid in full.

The other type is payable in volumes (volumetric production payments).

Current practice

The first type of production payment is accounted for as borrowings under *IAS 39 Financial Instruments: Recognition and Measurement*.

For the second type of production payment, the entity receiving the funds accounts for these as unearned revenue which will be recognised as the oil or gas is delivered.

Potential impact of new proposals

The accounting for arrangements where repayments are made in cash is likely to be unaffected by this ED. Therefore, they will continue to be accounted for as financing transactions under IAS 39.

Whether volumetric production payments fall within the scope of this ED will depend upon whether or not the counterparty is considered to be a customer. If the counterparty is not considered to be a customer, such transactions would be outside of scope and current accounting may be able to continue.

However, should the counterparty be considered a customer, then the following would be likely to occur:

- ▶ A contract liability related to the unsatisfied performance obligation to deliver oil or gas in the future would be recognised when the consideration is received. This may be difficult to reliably measure where future production levels are highly uncertain.
- ▶ Revenue would be recognised as the performance obligation is satisfied.
- ▶ The time value of money would have to be incorporated (if material), which may result in increased revenue ultimately being recognised as well as interest expense, which is not currently required.

For additional guidance on the accounting for the time value of money, see our general revenue recognition publication referenced in the introduction.

How we see it

Similar to other transactions, determining whether the proposed revenue recognition model will impact current accounting will depend upon whether or not the counterparty is considered to be a customer. If they are considered to be a customer, the complexity in measuring and recognizing revenue may increase and could impact the quantum and type of items recognised in profit or loss, including revenue and interest expense.

Take-or-pay contracts

A take-or-pay contract is an agreement between a buyer and seller in which the buyer will still pay a specified minimum amount even if the product or service is not provided. Some take-or-pay agreements include a clause that allows a customer to 'make up' the missing output/capacity at a later date. The ability to make-up the unused volumes at a later date means that consideration has been received in advance by the gas producer for a product that has not yet been delivered.

Current practice

Under current IFRS, revenue is recognised as follows:

- ▶ Volumes taken:
 - ▶ Revenue is recognised when the volumes of the product concerned, e.g., gas, are actually delivered and they are measured at the applicable price at that time, e.g., market price or contract price (as specified in the contract)
- ▶ Volumes not taken but paid for:
 - ▶ Where the customer is not entitled to future recovery of the gas paid for, but not taken, revenue is recognised when the payment is due from the customer.
 - ▶ Where the customer is entitled to apply the payments made in relation to unused gas to future deliveries of gas, the amount paid by the customer is recognised as deferred revenue, and is recognised as revenue either when the payment is applied to future deliveries or the right to apply the payment to such deliveries expires unused.

Potential impact of new proposals

Some of the key aspects of the proposed new model which will increase the complexity of, and may change the accounting for, take-or-pay contracts are:

- ▶ Determining whether a long-term take-or-pay contract should be segmented into multiple contracts and/or whether separate performance obligations should be identified
- ▶ Determining and allocating the transaction price
- ▶ Accounting for payments received for unused gas that can be made up by applying to future volumes.

To illustrate these, we use the following example:

- ▶ Oil and gas company A enters into a five year take-or-pay contract for a minimum of 1,000 MMBtu of gas per year. The amount paid for each MMBtu is the market price as calculated in accordance with the terms of the contract, e.g., the volume weighted market price 5 days prior to delivery or for minimum volumes not taken, 5 days prior to the end of that contract year.
- ▶ In Year 1, Company A delivers 900 MMBtu. The purchaser is required to pay for the full 1,000 MMBtu, but it is permitted to make up the 100 MMBtu in a subsequent period. CU500 is received by Company A in relation to the 100 MMBtu of unused gas.

Identifying the contract and performance obligations

Segmenting the contract

The ED considers the concept of segmenting a contract if certain criteria are met. That is, while there may be only one physical contract, for the purposes of revenue recognition, it may be considered to be multiple contracts. Segmentation is required where the prices of some goods or services in the contract are independent of other goods and services in the contract.

While we understand that the purpose of segmenting contracts is to effectively “ring fence” the allocation of the transaction price, i.e., subsequent changes in the transaction price attributable to a segment of a contract are only allocated to the performance obligations within that segment, this is not necessarily clear within the current wording of the ED. Without further clarification, it may be difficult to determine if a take-or-pay contract comprises multiple contracts, and/or multiple performance obligations (refer below).

Considering the example above:

- ▶ Is there one contract spanning five years for the delivery of a minimum of 5,000 MMbtu of gas?

or

- ▶ Are there five contracts for the delivery of 1,000 MMbtu of gas per year?

Identifying performance obligations

Regardless of the number of contracts that are identified, an entity needs to identify all promised goods or services and then account for each as a separate performance obligation where they are distinct. Our general revenue recognition publication mentioned above explores in more detail what is meant by “distinct”.

One of the potential issues with this requirement is determining the level of granularity needed to identify these performance obligations. Based on the proposed guidance, it may be difficult for entities to identify the performance obligations in transactions including a large number of goods or services delivered over a period of time, e.g., take-or-pay contracts.

Again, considering the example above, some possible performance obligation scenarios may be that there is/are:

- ▶ One performance obligation for the delivery of 5,000 MMbtu of gas
- ▶ Five performance obligations for the delivery of 1,000 MMbtu of gas per year

or

- ▶ 5,000 performance obligations for the delivery of 1 MMbtu of gas over five years.

Determining how a take-or-pay contract should be accounted for will have significantly different implications for revenue recognition. The ED, however, is not necessarily clear as to how this determination should be made.

Determining the transaction price

The transaction price reflects the probability-weighted amount of consideration that an entity expects to receive from the customer in exchange for transferring the goods or services.

Variable consideration

The ED states that, where the transaction price is variable, an entity should only recognise revenue where the transaction price can be reasonably estimated. If an entity lacks the ability to make a reasonable estimate, the transaction price is limited to the amount of consideration that is fixed or that can be reasonably estimated.

Our general revenue recognition publication explores some of the factors to be considered when assessing whether the transaction price can be reasonably estimated. One such factor is the degree to which the consideration is highly susceptible to external factors, such as market volatility.

The other significant change in the ED is the requirement to update the transaction price for subsequent changes and allocate these changes to each of the performance obligations - both those that have been satisfied and those that are still outstanding.

This will increase complexity, and depending on how this is interpreted, could potentially lead to some very unusual revenue recognition profiles.

The nature of take-or-pay contracts is that they tend to extend over long periods of time and, generally, the prices are not fixed, instead, they are often based on/ derived from market prices. Therefore, estimating the transaction price at contract inception and throughout the contract period may prove to be difficult or may not be possible.

To illustrate this point, consider the fact pattern in the example above – assume

there are five performance obligations to deliver 1,000 MMBtu of gas per year over five years and that the customer takes the minimum amount each year, in full, at the same time each year, and pays the market prices listed below. A potential interpretation of the requirements regarding variable consideration based upon market factors, could inappropriately lead to the following revenue recognition profile:

Table 1: Comparison of potential revenue recognition profiles

Year	Quantity MMBtu	Price per MMBtu	Cumulative revenue	Revenue recognised in period		Calculation under new model
				IAS 18	Proposed model	
1	1,000	CU5.00	5,000	5,000	1,000	(5,000 / 5)
2	1,000	CU5.50	10,500	5,500	3,200	((10,500 / 5 x 2) - 1,000**)
3	1,000	CU4.50	15,000	4,500	4,800	((15,000 / 5 x 3) - 4,200**)
4	1,000	CU5.00	20,000	5,000	7,000	((20,000 / 5 x 4) - 9,000**)
5	1,000	CU6.00	26,000	6,000	10,000	((26,000 / 5 x 5) - 16,000**)

** Already recognised in revenue in prior period(s)

For simplicity, the impact of other factors, such customer credit, has been ignored.

Given the variable nature of the consideration, the transaction price for the whole contract is only considered to be capable of being reasonably estimated progressively as the actual sales occur. Therefore, as each sale occurs, the transaction price needs to be re-estimated and reallocated, which could result in the unusual revenue recognition profile above.

While the example above is over-simplified, it attempts to demonstrate how determining the profile of revenue allocation could be a significant practical issue in accounting for take-or-pay contracts.

How we see it

Based on more recent discussions with IASB staff, it is our understanding that this interpretation was not the intended outcome for take-or-pay contracts. Instead, it was intended that, in a situation like the example above, where each portion of the transaction price can only be determined for each performance obligation as it occurs, i.e., effectively when the gas is actually delivered or not taken by the end of the period, the known transaction price should only be allocated to the related performance obligation as it occurs.

In the above example, in Year 1, CU5,000 would be the known transaction price and would only be allocated to the first performance obligation i.e., the deliveries made in Year 1. The remaining portion of the transaction price of the contract would not be reasonably estimable. Then in Year 2, CU5,500 would be the next part of the transaction price that is known and it would only be allocated to the Year 2 performance obligations.

While this may have been the intention, it is not clear how the current wording within the ED would enable this outcome to be arrived at. Therefore, this would need to be clarified in the final standard.

Impact of the time value of money

The proposed model requires that the promised consideration in a contract shall be adjusted to reflect the time value of money where the contract includes a material financing component (explicitly or implicitly).

In most instances, the time value of money will not be material. However, the effect may be material where the payment from the customer is received either significantly before or after the transfer of goods or services.

In take-or-pay contracts, where payments received for unused gas can be applied to future volumes, the seller has a performance obligation that has not been satisfied, for which consideration has been received in advance. This amount represents a contract liability. In determining whether the time value of money is material (which impacts the measurement of the transaction price, and consequently, the contract liability), an entity will need to estimate when such future volumes are expected to be taken.

Such a determination will be made after consideration is given to the terms of the contractual agreement in conjunction with an assessment of the expected customer behaviours.

For example, such an assessment may involve considering whether the make-up volumes are:

- ▶ The first volumes taken at the start of the immediately subsequent period
- ▶ The volumes that can be taken only after the minimum has been taken in the immediately subsequent period or some other future period

or

- ▶ Amounts that can only be taken at the end of the contract period.

If an entity decides that the time value of money is significant, it would need to impute interest on the contract liability. That is, an interest expense would need to be recognised over the period and the value of the contract liability would increase. As a result, the final amount of revenue recognised would be higher when the performance obligation is satisfied.

Using the example above, at the end of Year 1 payment of CU500 is received related to the 100 MMbtu of gas not taken and a contract liability of CU500 is initially recognised.

Satisfaction of the performance obligation related to the 100 MMbtu is expected to occur only after the subsequent period's minimum is met. Company A determines the discount rate on a similar borrowing.

In Year 2, Company A delivers 1,100 MMbtu of gas, the last 100 MMbtu of which is delivered in the last month of the year.

During Year 2, Company A recognises interest expense of CU46 [CU500 x 10% x 11/12] and increases the contract liability by the same amount. Therefore, immediately before the performance obligation is satisfied, the contract liability is CU546.

The entity would then recognise revenue of CU546 when it transfers the gas to the customer in the last month of the year.

- ▶ IAS 18 does not explicitly address time value of money. It is implicitly incorporated in the requirement to recognise revenue at the fair value of the amount to be received. However, it would appear that the practice of incorporating the impact of the time value of money is divergent.

For additional guidance on accounting for the time value of money, see our aforementioned general revenue recognition publication.

How we see it

The proposed new revenue recognition model could have significant practical implications for the accounting for take-or-pay contracts. Given the variable nature of the consideration to be received under these contracts, there is a concern that the resultant revenue profile would not reflect the commercial understanding of such arrangements.

There is, however, still a considerable lack of clarity as to exactly what the actual impact will be.

Having said this, it seems, based on the current proposals, that the complexity in accounting for these arrangements would increase significantly.

Inventory exchanges

From time to time, entities in the oil and gas industry may exchange inventory with other entities in the same line of business. This may be to supplement current production. This can happen if suppliers might be short of requirements at present, but will exceed requirements in the future. It enables efficient use of excess production today, or helps to achieve lower transportation costs.

Current practice

Currently, IAS 18 states that when goods or services are exchanged or swapped for goods or services which are of a similar nature and value, the exchange is not regarded as a transaction which generates revenue.

Potential impact of new proposals

The scoping section of the ED states that it will apply to all contracts with customers except (amongst other things):

“ ... non-monetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange (for example, an exchange of oil to fulfil demand on a timely basis in a specified location) ... ”

While such parties could technically meet the definition of a customer, for various reasons, the Boards decided to scope these exchanges out.

How we see it

It is our understanding the Boards did not expect the treatment of inventory exchanges to change as a result of the proposed new model. However, we do not believe that this has been made clear in the wording of the ED.

The change in the wording from goods or services that are “similar in nature and value”, to exchanges between entities in the “same line of business”, means that it is unclear whether some transactions that are currently treated as exchanges of dissimilar goods and hence, are revenue generating, may now not be considered to be revenue generating because the entities are in the same line of business.

Also, while the scoping section of the ED makes it clear that inventory exchanges do not result in revenue generation, it does not provide guidance on how such transactions should be accounted for. Given the lack of clarity, the divergence in accounting may continue.

Royalty payments

Oil and gas entities frequently enter into royalty arrangements with owners of mineral rights. Often these are payable upon the extraction and/or sale of the oil or gas. The royalty payments may be based on a specified rate per volume of product or the entity may be obliged to dispose of all of the relevant production and pay over a specified proportion of the aggregate proceeds of sale, often after deduction of certain lifting, (e.g., conveying and treating) costs.

In other arrangements, the royalty holder may have more of a direct interest in the underlying production and may make lifting and sale arrangements independently. This is often seen in some royalty agreements in the US.

The issue, from a revenue recognition perspective, would be whether revenue should be recognised gross or net of these royalty payments.

Current practice

Currently, the accounting treatment for government and other royalties payable is diverse. Sometimes, all invoiced quantities are included in revenue, and royalty payments are charged either as a cost of sales or as a tax. In other cases, they are excluded from both the value of reported revenue and cost of sales/taxes on the basis that the entity has no legal right to the royalty product.

Potential impact of new proposals

While the ED and associated guidance do discuss some of the issues affecting gross vs. net presentation, they do not directly address the treatment of royalties.

Having said that, the ED requires revenue to be recognised at the “transaction price” and Appendix A defines the transaction price as:

“... the amount of consideration that an entity received, or expects to receive, from a customer in exchange for transferring goods or services, excluding amounts collected on behalf of third parties (for example, taxes).”

Other than this, there is no additional guidance provided. Consequently, the ED does not clarify whether a royalty is a cost of production/tax, and therefore, revenue should be recognised gross. Nor does the ED disclose whether a royalty is considered a tax collected on behalf of the lessor (which is usually the government, but could be another party) and, hence, would be excluded from revenue.

How we see it

It is unclear from the revenue recognition ED whether revenue should be recognised gross or net of royalty payments. Without further guidance, divergence is likely to continue.

Next steps

Oil and gas companies should familiarise themselves, not only with the matters outlined in this publication, but also with the details of the new revenue recognition model. While the comment period in relation to the ED is now closed, the standard is not yet finalised and may differ from the ED.

Therefore, companies should continue to consider the impact the changes may have on their business. They should also continue to discuss these potential changes with the Audit Committee, the Board and their auditors. Furthermore, entities should consider the process for communications with shareholders, analysts and other users.

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