

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 oilfield services sector. This issue provides a high-level overview of the potential implications of the new revenue recognition proposals.

Introduction

We recently 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 discussed 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 oilfield services sector. The impact for the oil and gas sector has been considered in a separate publication entitled *Revenue from Contracts with Customers – impact on the Oil and Gas sector*.

The issues discussed here are intended both to 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

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 is not changing 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. 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 is completely different under the new lease model, this assessment will have significantly different accounting implications where service contracts are considered to contain embedded leases.

Day rate drilling contracts

Drilling contracts generally lay out specifications with respect to the drilling rig and equipment, timing and personnel. They either provide for charges based on day rates for operating, standby and repair (e.g., offshore drilling contracts) or are based on the depth drilled (land drilling contracts). In addition, there are specified rates for certain personnel and services (catering, etc.). Drilling contracts may be short term or long term and may have options to extend.

Current practice

Revenue from these contracts is generally recognised as the services are provided, i.e., on a per day, or part thereof, basis, at the daily rate per the contract.

Potential impact of new proposals

Applying the scope exclusions

As outlined above, 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 first. Given this, drillers will need to determine if the contract is a lease, a lease with a service component or strictly a service contract (see the "Scope" section above).

If the contract is a lease or a lease with a non distinct service contract, the entire contract is accounted for under the lease accounting model. If the contract has a lease and service component and the service component is distinct, then these would need to be separated and accounted for under the respective models (i.e., the lease under the lease model and the service component under the proposed revenue recognition model).

Once the service component is separated (or if the contract is determined to be strictly a service contract), the drilling entity will need to identify the distinct performance obligations in the contract.

Identifying performance obligations

Drilling entities will need to assess whether there are services (e.g., catering, transportation, drilling materials and supplies, rental tools, etc.) in drilling contracts that represent separate performance obligations. The criterion specified in the proposed revenue guidance for determining whether there are separate performance obligations is whether the goods and services provided under the contract are distinct.

A good or service is considered distinct if:

1. The entity or another entity sells an identical or similar good or service separately; or
2. The entity could sell the good or service separately because the good or service meets both of the following conditions:
 - ▶ It has a distinct function (i.e., it has utility either on its own or together with other goods or services); and
 - ▶ It has a distinct profit margin (i.e., it is subject to distinct risks and the entity can separately identify the resources needed to provide the good or service)

Identifying the performance obligations in the contract under the proposed guidance is based on the individual facts and circumstances of the contract.

Determining the transaction price

The next step under the proposed revenue recognition model is determining the transaction price for the service component of the drilling contract. As a significant portion of the compensation may be variable (i.e., different day rates for different activities, bonuses and other variable consideration), a drilling entity may need to perform a probability-weighted estimate based on the expected utilisation of the drilling rig to calculate the transaction price (if it can be reasonably estimated), including the time-value of money, if significant.

For example, an entity could estimate a probability-weighted operating day rate to be used over the service term. Subsequent changes in the transaction price are required to be updated each reporting period under the proposed model and will result in changes to current period revenue for already satisfied performance obligations. The initial and subsequent determination of the transaction price could be quite difficult and time consuming. Revisions to the estimated transaction price that are related to satisfied performance obligations will affect revenue in the period of the revision, which could result in volatility.

Recognising revenue

Revenue for the service component of the drilling contract is recognised when a performance obligation is satisfied, which is when the customer obtains control.

How we see it

Depending upon the services provided as part of the drilling contract and an entity's assessment of whether these represent distinct performance obligations, and how the transaction price is determined and then allocated to these individual performance obligations, the revenue recognition profile of a drilling services company may change.

Construction and manufacturing contracts

For companies in the oilfield services subsector that have construction and manufacturing contracts currently accounted for under the percentage of completion method or footage rate drilling contracts, please see the discussion on continuous transfer of control in our broader revenue recognition publication referred to on page 1.

Some key points under the proposed revenue recognition guidance for companies currently using the percentage of completion method include the following:

- ▶ Where multiple goods are contracted for under a single contract (e.g., if a company is contracted to construct 10 land rigs), need to determine if this should be segmented into 10 separate contracts or whether it represents 10 separate performance obligations
 - ▶ Segmentation is required where the price of some goods or services in the contract is independent of other goods and services in the contract

- ▶ Identifying the individual activities performed under the contract and determining which activities are distinct and which are integrated and should be combined into a single performance obligation (see appendix B40-43 in the ED)
- ▶ Accounting for change orders and whether they should be incorporated in the current contract accounting (e.g., if there is a discount) or should be accounted for as a separate contract
- ▶ Including variable consideration (e.g., bonus payments) and the time value of money (if significant) when estimating the transaction price
- ▶ Recognising revenue differently for performance obligations within the same contract (e.g., one performance obligation may be subject to continuous transfer and one may be subject to delivery of a good at a point in time)
- ▶ Determining whether continuous transfer is appropriate
 - ▶ Entities must consider when control is transferred to the customer. If the product is significantly customised for the customer, it may be an indicator that there is continuous transfer regardless of where the construction or manufacturing occurs
 - ▶ Another consideration is whether certain standardised equipment used in the construction or manufacturing of a customised good would affect the accounting (see appendix B63 – B66 in the ED)

- ▶ Determining how customer acceptance provisions will impact revenue recognition. Entities will need to determine whether they can objectively determine that control of a good or service has been transferred in accordance with the agreed upon acceptance terms
- ▶ Determining the impact any warranty provisions that may be included as part of the contract may have upon revenue recognition. The ED identifies two specific classes of warranties, which we have described as:
 - ▶ *Quality assurance warranties:*
Those that cover latent defects i.e., defects that existed at the time the goods were transferred to the customer
 - ▶ *Insurance warranties:*
Those that cover defects that arise subsequent to the transfer of the goods

For further details of the potential implications of each type of warranty on revenue recognition, read our broader revenue recognition publication referred to on page 1

- ▶ Recognising costs associated with wasted materials, labor or other resources as an expense
- ▶ Evaluating each performance obligation to determine if it is onerous. A single performance obligation could be onerous while the contract as a whole is expected to be profitable

How we see it

A key take-away for entities that currently account for contracts using the percentage of completion method is that while the proposed guidance does still provide for a continuous transfer model, and an input method (e.g., costs of resources consumed) is specified as one of the three acceptable methods that may be used, it is possible that there may be significant differences in the pattern of revenue recognition and margins depending on the performance obligations identified and when transfer of control occurs.

Entities will need to perform detailed analyses of their contracts to determine the appropriate accounting.

Seismic services

There are two primary services provided by seismic companies. One service is customer specific and includes data acquisition and/or processing at a specified location. Data acquisition includes geological surveying and accumulation of other data while processing includes interpretation of that data. Another service is providing a licence to information from data accumulated by the company that is not customer specific (i.e., a data library).

Data acquisition and processing

Seismic companies enter into contractual arrangements with customers to perform data acquisition and/or processing for a specified area of interest.

Current practice

Revenue is recognised as the seismic data is acquired and/or processed on a proportionate basis using quantifiable measures of progress, such as kilometres acquired or days processed.

Potential impact of new proposals

Seismic companies will need to identify the performance obligations in the contract and determine whether they are distinct and require separation (see criteria in the “Day rate drilling contracts” section above).

If the entity, or another entity, sells data acquisition services separate from processing services, then the performance obligations would be considered to be distinct. Furthermore, if an entity could perform data acquisition and processing services on a standalone basis because they have a distinct function and margin, those services would be considered distinct. As a result, seismic companies will need to determine the transaction price for the contract and allocate it to each performance obligation based on its relative standalone selling price. Because seismic companies perform those services separately, estimating the standalone selling price may not be a significant challenge.

Revenue would then be recognised when the performance obligations were satisfied by transferring a good or service to a customer, which would occur when the customer obtains control of the good or service. In most cases, the customer directs the activities of the entity and has the right to the raw data as it is being acquired. That is, if the customer cancels the contract with the seismic entity, they are entitled to the data that has been captured and/or processed to date. With such customisation, the services would be considered to be transferred to the customer on a continuous basis.

The proposed guidance indicates that output methods, input methods, and methods based on the passage of time are suitable for recognising revenue on continuous transfer of goods or services. As a result, there may not be a significant difference between current IFRS and

the proposed ED in the method used to recognise revenue. However, the timing and amount may differ depending on how the transaction price is allocated to the individual performance obligations and the customer's rights to the output.

Example – seismic data acquisition and processing

Seismic Company is contracted to perform data acquisition and processing services on Area A for Oil and Gas Company for a fixed fee of \$120,000. Seismic Company identifies the acquisition and processing services as separate performance obligations. Seismic Company estimates the standalone selling price of data acquisition costs to be \$130,000 and the standalone selling price of processing services to be \$10,000. The transaction price is allocated to each performance obligation as follows:

	Stand alone selling price	Factor	Allocated transaction price
Acquisition	\$130,000	0.92	\$110,400
Processing	\$10,000	0.08	\$9,600
	\$140,000		\$120,000

In this example, \$110,400 will be recognised as the acquisition services are performed (e.g., using an output method based on miles shot) and \$9,600 will be recognised as processing services are performed (e.g., using passage of time based on the number of days to completion) on the assumption of continuous transfer of control. While there may be some overlap in the services being provided, the timing of revenue recognition may differ from current IFRS under the proposed guidance.

How we see it

Entities will need to undertake further analysis to identify the separate performance obligations, determine the transaction price, determine whether there is actually continuous transfer of control and then allocate this to the various performance obligations. Consequently, it is possible that the timing of revenue recognition may change.

For seismic licences, the customer is granted the right to the data at a particular point in time for the customer's internal use. The entity has no further obligation under the licence. Therefore, revenue under the proposed guidance would be recognised when the customer has obtained the right to the information.

How we see it

Generally, the accounting for non exclusive data licences should be consistent with current revenue recognition practices.

Data licencing

Seismic companies may acquire and process data on areas of interest that are not under contract by a customer and maintain the data in a library for future sale through non exclusive licencing arrangements.

Current practice

Revenues on licences of completed surveys are currently recognised when an agreement is entered into, the purchase price for the licence is fixed or determinable, delivery or performance has occurred, and no significant uncertainty exists as to the customer's obligation, willingness or ability to pay.

Potential impact of new proposals

Appendix B35 of the ED explains that if non exclusive rights are granted to a customer, then those rights give rise to a single performance obligation and the performance obligation is satisfied when the customer is able to use and benefit from the rights, which is no sooner than the beginning of the licence period.

Next steps

Oilfield services 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. Further, entities should consider the process for communications with shareholders, analysts and other users.

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