What you need to know

- In November 2018, the IFRS IC discussed how a joint operator accounts for output from a joint operation when the output it receives in a reporting period differs from the output that it is entitled to.

- The Committee concluded that the joint operator recognises revenue only to the extent that it depicts the transfer of output to its customers in each reporting period (i.e., revenue recognised applying IFRS 15). This means in a joint operation in the oil and gas industry, the joint operator only recognises revenue for the output that it has sold to the customer (as defined in IFRS 15), regardless of what output the joint operator is entitled to.

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Highlights

A topical issue raised during the implementation of IFRS 15 Revenue from Contracts with Customers is how a joint operator (as defined in IFRS 11 Joint Arrangements) accounts for output arising from a joint operation when the output it receives in a reporting period differs from the output to which it is entitled.

On 27 November 2018, the IFRS Interpretations Committee (the IFRS IC or the Committee) issued a Tentative Agenda Decision (TAD) setting out that the joint operator recognises revenue only to the extent that it depicts the transfer of output to its customers in each reporting period (i.e., revenue recognised applying IFRS 15). This means in a joint operation in the oil and gas industry, the joint operator only recognises revenue for the output that it has sold to the customer (as defined in IFRS 15), regardless of what output the joint operator is entitled to.

The Committee concluded that existing International Financial Reporting Standards (IFRS) provide an adequate basis for a joint operator to determine its revenue from the sale of output from a joint operation. Consequently, the Committee tentatively decided not to add this matter to its standard-setting agenda. The Committee discussed (but did not comment on) the basis and measurement of any accrual or deferral of expenditures associated with a joint operator’s share of output during a reporting period.

The comment period closes on 6 February 2019. The earliest meeting at which this matter can be discussed is scheduled for 5 March 2019; this is after many entities will have reported their first full year results applying IFRS 15. We recommend that entities disclose the accounting treatment adopted for revenue and cost of goods sold, the assumptions used and judgements made, in their 2018 financial reports.
Background

In jointly-operated oil and gas operations, it is often not practical for each participant to take in kind or sell its exact share of production during a period. Consequently, at the end of a given period, some joint operators will be in an overlift position (i.e., they have taken more product than their proportionate entitlement), while other joint operators will be in an underlift position (i.e., they have taken less product than their proportionate entitlement).

Generally, costs are invoiced to each joint operator in proportion to their entitlement to output, which does not normally match the costs that would be incurred for the volumes actually lifted and sold. Imbalances between volumes to which they are entitled (for which production costs are recognised) and volumes lifted and sold (for which revenue is recognised in accordance with IFRS 15), may be settled between/amongst joint operators either in cash or by physical settlement. The accounting may differ depending on the specific terms of the joint operating agreement or production sharing arrangement.

The submission to the Committee was based on the following fact pattern:

- A number of parties enter into an (unincorporated) joint arrangement by entering into a joint operating agreement (JOA)
- The JOA specifies each party has a right to receive a fixed proportion of the output arising from the joint operation, and an obligation to pay a fixed proportion of production costs incurred
- For operational reasons, in any given reporting period, the output each joint operator receives may be more, or less, than its share of output, and the joint operator will transfer all of the output it receives to its customers. However, the joint operator still pays for only its proportionate share of the production costs incurred
- The imbalance that arises will be settled through future deliveries of output

Historical practice

Historically, two methods of accounting for revenue have been applied in the oil and gas sector – the sales method and the entitlements method. Such practice under IFRS was primarily a consequence of entities applying the hierarchy in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, and guidance from other sources, including US GAAP, the former UK OIAC SORP 1 and former Australian GAAP.

Under the sales method, revenue was recognised based on the value of product sold. Under the entitlements method, revenue reflected a joint operator’s share of production, regardless of which participant in the joint operation had actually made the sale to a customer. Adjustments required to reflect economic entitlement to output were recorded by either adjusting revenue or cost of goods sold.

Recent developments, including the implementation of IFRS 15, challenge the extent to which the guidance remains relevant. The SEC staff announced in March 2016 that it would rescind guidance that provided US GAAP upstream oil and gas entities with the choice to use either the sales method or entitlements method to account for production and sales imbalances (e.g., gas imbalances). This would

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1 UK Oil Industry Accounting Committee (OIAC) Statement of Recommended Practice (SORP) on Accounting for Oil and Gas Exploration, Development, Production and Decommissioning Activities.
be effective upon adoption of the US GAAP equivalent to IFRS 15 (Accounting Standards Codification (ASC) 606, Revenue from Contracts with Customers).²

The decommissioning of the former UK OIAC SORP, coupled with the need to apply IFRS where available, has resulted in the guidance set out in the former UK OIAC SORP becoming less relevant.

**Revenue recognition under IFRS 15**

Under IFRS 15, revenue from sales to external customers is recognised when the joint operator satisfies its performance obligation by transferring control of a promised good or service (i.e., an asset) to the customer.³ Timing of recognition will depend on the terms of trade used, but will generally occur at the point in time that the product is physically transferred into a vessel, pipe or other delivery mechanism and the customer accepts the product.

Other transactions with joint operators, such as cost sharing arrangements, are unlikely to fall within the scope of IFRS 15 and, hence, may not form part of revenue from contracts with customers.⁴ This is consistent with the Basis for Conclusion to IFRS 15,⁵ the March 2015 IFRS IC Agenda Decision on IFRS 11 (Recognition of revenue by a joint venture) and IFRS 11, which states that ‘a joint operator shall account for the assets, liabilities, revenues and expenses relating to its interest in a joint operation in accordance with the IFRSs applicable to the particular assets, liabilities, revenues and expenses’.⁶

**The question posed to the IFRS IC**

The Committee was asked how a joint operator accounts for output arising from a joint operation when the output it receives in a reporting period differs from the output to which it is entitled. In its response, the Committee focused predominantly on output from the joint operation and associated revenue recognition.

The TAD states that the joint operator recognises revenue only to the extent that it depicts the transfer of output to its customers in each reporting period, i.e., revenue recognised applying IFRS 15. The TAD also explains that the joint operator does not recognise revenue for the output it has not lifted and sold.

**The cost side of the equation**

The question, and the subsequent discussion, did not focus on the mismatch that arises if revenues are recognised based on actual output sold, whereas costs are invoiced from the joint operation in proportion to the joint operator’s entitlement to output.

The current diversity in practice in respect of accounting for this mismatch is due, at least in part, to different perspectives on the basis for any accrual, or deferral, of expenditures where there is a difference between the costs associated with the output sold (and thus recorded as revenue), and the costs incurred based on entitlement to output. That is, the accounting depends on whether the

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² The SEC Observer comment to the Emerging Issues Task Force (EITF) on Accounting for Gas-Balancing Arrangements (formerly EITF 90-22) was codified in ASC 932-10-599-5 and rescinded by FASB-ASU-2016-11 Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Recession of SEC Guidance because of Accounting Standards Updates 2014-09 and 2014-16 pursuant to staff announcements at the March 3, 2016 EITF Meeting.
³ IFRS 15.31.
⁴ IFRS 15.5(d), 6.
⁵ IFRS 15.BC52-BC56.
⁶ IFRS 11.21, IFRS 15 BC52-BC56.
adjustment is considered to record either: 1) a prepayment or accrual for production costs; or, 2) a right to, or obligation for, the provision of petroleum product in the future.

If it is considered to be a prepayment or accrual of production costs, the adjustment to cost of goods sold would likely be recorded at cost. If it is considered to represent a right to, or obligation for, the provision of petroleum product in the future, fair value measurement may be more appropriate.

The accounting for the adjustments to cost of goods sold may also depend on whether the imbalances are settled between/among joint operation participants in cash or by physical settlement and/or according to the terms in individual contractual arrangements.

If an adjustment is recorded in cost of goods sold at fair value, this will result in a joint operator's gross margin that reflects the gross margin that would be earned based on its entitlement interest. If an adjustment were recorded through cost of good sold at cost, the gross margin shown would reflect the gross margin attributed to the volumes actually sold to customers.

**Next steps**

Responses to the TAD are due by 6 February 2019. It is not yet clear whether this matter will be discussed at the March 2019 IFRS IC meeting or at a later date.

**How we see it**

We concur with the IFRS IC's view that revenue should be recognised in accordance with IFRS 15. Recording adjustments to recognise revenue for output to which an entity is entitled, but has not lifted and sold, is not appropriate.

However, it is not clear whether adjustments for the difference between output entitled to and output actually lifted and sold should be made to cost of goods sold, and whether the adjustments should be recorded at cost or at fair value. Absent further clarity on this point, it is likely that diversity in practice will continue.

Many oil and gas entities are due to release their first annual results incorporating the adoption of IFRS 15. Entities should disclose the accounting treatment adopted in respect of this matter, the assumptions used and judgements made in their 2018 financial reports, if material. This includes judgements and assumptions in respect of any adjustment recorded to costs of goods sold, to aid comparability between financial reports in the oil and gas sector.

Although the Committee have focused their deliberations on an oil and gas fact pattern, similar arrangements may exist for joint operations in other sectors and, if so, the TAD would be applicable.