
Ihre Ansprechpartner

Sehr geehrte Damen und Herren,

für Rückfragen zur beigefügten Ergänzung „Oil and gas industry supplement for IFRS“ zu unserer Publikation „In depth“ zur Thematik „Revenue from contracts with customers“ stehen Ihnen folgende Ansprechpartner gerne zur Verfügung:



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In-depth

A look at current financial reporting issues

Revenue from contracts with customers ***The standard is final – A comprehensive look at the new revenue model***

Oil and gas industry supplement for IFRS

No. 2014-02 (supplement)
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At a glance

On 28 May 2014, the IASB and FASB issued their long-awaited converged standard on revenue recognition. The standard introduces a number of challenges to preparers, as evidenced by the deferral of the effective date (as agreed at the IASB meeting on 22 July 2015) and the level of activity at the Transition Resource Group.

Entities in the oil and gas industry sometimes enter into complex contractual arrangements relating to the sale of products. The complexities around pricing and delivery are likely to be affected to some extent by the new standard, including requirements to identify separate performance obligations and determine the extent to which transaction prices are subject to the risk of significant reversal. The new requirements could affect the timing and measurement of revenue recognised. There is also a significant increase in the disclosure required.

[In depth INT 2014-02](#) is a comprehensive analysis of the new standard. This supplement highlights some of the areas that could create the most significant challenges for oil and gas entities as they transition to the new standard.

Overview

Revenue recognition in the oil and gas industry may appear straightforward. Revenue is generated through the supply of commodities in exchange for consideration. Complexities can arise, however, from certain types of contractual arrangements that are common to the industry, including partnerships with other entities and arrangements for which the consideration is based on future production. Agency arrangements, transportation services, provisionally-priced commodity sales contracts and long-term take-or-pay arrangements might also be impacted by the new revenue standard. The complexities in these areas can make the decision of when to recognise revenue under the new standard and how to measure it more challenging.

This supplement focuses on how the standard will impact entities in the oil and gas industry and highlights potential differences with current practice under IFRS. The examples and related discussions are intended to provide areas of focus to assist entities in evaluating the implications of the new standard.



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Scope

The new revenue standard applies to contracts with customers and does not exclude extractive activities from its scope. Oil and gas entities will need to use judgement as they evaluate whether or not the parties in the transaction have a vendor-customer relationship, and therefore fall within the scope of IFRS 15.

Definition of a customer

A customer is a party that contracts with an entity to obtain goods or services that are the output of that entity's ordinary activities. 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 activities. It excludes transactions arising from arrangements where the parties are participating in an activity together and share the risks and benefits of that activity.

Production sharing arrangements

Governments are increasingly using production sharing arrangements (PSAs) to facilitate the exploration and production of their country's hydrocarbon resources by using the expertise of a commercial oil and gas entity. In such arrangements, it might be challenging to determine whether the government is a customer, and therefore whether the arrangement is within the scope of IFRS 15. Under a typical PSA, an oil and gas entity will be responsible for all of the exploration costs, as well as some or all of the development and production costs associated with the hydrocarbon interest. In return, the oil and gas entity is usually entitled to a share of the production, which will allow the recovery of specified costs plus an agreed profit margin.

PSAs, including royalty agreements, are becoming more complex and the terms might vary even within the same jurisdiction. Governments often write specific legislation or regulations for each significant new field. Each PSA should be evaluated and accounted for in accordance with the substance of the arrangement to determine whether the government meets the definition of a customer and is within the scope of the standard:

- A PSA in which the government is not a customer is outside the scope of the new standard. The oil and gas entity would recognise the construction of its own tangible assets and would apply other relevant guidance including guidance on property plant and equipment, intangible assets and exploration. Revenue would be recognised when the oil and gas entity delivers its share of production to its customers. The cost of the share of production delivered to the government would be an operating cost.
- A PSA in which the government is a customer is in the scope of the new standard. The proposed guidance requires the operator to recognise revenue for the delivery of services, which might include exploration or construction services, in exchange for future production. The future production would be variable non-cash consideration and would affect the measurement of revenue.

Forward-selling contracts to finance development

Hydrocarbon exploration and development is a capital intensive process. Oil and gas entities use different financing methods including structured transactions which involve selling future production from specified properties to a third-party "investor" for cash. This cash is used to fund the development of a promising prospect. Such structures come in many different forms (for example, streaming arrangements) and each needs to be carefully analysed to determine the appropriate accounting.

Our publication "[In Depth – Alternative financing for extractive industries](#)" examines the accounting for these types of arrangements. The new standard might mean a significant change from current accounting practice for alternative financing arrangements. The complexity of these structures means that careful analysis will be required by oil and gas companies before reaching a conclusion on the appropriate accounting.

Product exchanges



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Oil and gas companies often exchange or swap products, such as crude and refined oil, with other oil and gas companies to achieve operational objectives. A common term used to describe this is a “Buy-sell arrangement.” The objective of these arrangements is often to save transportation costs by exchanging product A in location X for product A in location Y.

The new standard scopes out non-monetary exchanges, specifically “*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 coal to fulfil demand on a timely basis in a specified location).*” Non-monetary exchanges should be accounted for based on other guidance (paragraph 24 of IAS 16, ‘Property, Plant and Equipment’ is relevant).

The new standard is different than the guidance under previous IFRS. Non-monetary exchanges between entities in the same line of business that are not the end customer but are rather to facilitate sales to the end customer are outside the scope of the guidance, even if the exchange is of dissimilar products. This might widen the scope of transactions accounted for outside the scope of the standard.

The new standard also requires that there be a contract with a customer before revenue is recognised. A contract only exists if there is commercial substance (that is, the entity’s future cash flows are expected to change as a result of the contract). Judgement will be required to determine whether the contract has commercial substance. If there is no commercial substance to the exchange, the transaction is outside the scope of the standard and revenue should not likely be recorded.

Interaction with other standards

Contracts that are within the scope of other guidance under IFRS, such as leases or financial instruments, are outside the scope of the new standard. The standard provides application guidance for evaluating contracts with repurchase agreements that will assist oil and gas entities in determining whether the arrangement is a sale to a customer, a financing arrangement or a lease. This may impact some tolling agreements with refineries.

Recent developments

The Transition Resource Group (“TRG”) was formed by the FASB and IASB to advise the boards on implementation challenges. The TRG as well as the FASB and IASB continue to discuss potential actions in response to these challenges. Both boards have recently proposed changes to the standard that will be subject to relevant due process.

This supplement is based on the standard issued in May 2014. Preparers should monitor developments in those discussions, and consider the impact on accounting. A summary of the discussions is available at [‘In Transition’](#).

Oil & Gas imbalances - overlift and underlift

It is common in the oil and gas industry for entities to collaborate when developing assets and form joint arrangements. These arrangements share the physical output (for example, crude oil) between the parties. Each party is then responsible for either using or selling the output it takes.

The physical nature of “lifting” output, such as oil, means that it is often more efficient for each party to lift a full tanker-load at a time. The amount of oil lifted by each partner may not be equal to its ownership interest in a field at the balance sheet date. Some parties will have taken more than their share (over-lifted); others will have taken less than their share (under-lifted). Similarly, it is common for parties to a gas processing plant to be allocated and sell a volume of gas different from their entitled share of production for the period, resulting in a “gas imbalance.” Current practice is to view these transactions as being, in effect, a sale of oil or gas at the point of lifting by the underlifter to the overlifter as the criteria for revenue recognition in IAS 18 “Revenue” are considered to have been met.

It is not clear if other parties in a collaborative arrangement will meet the definition of a customer in the standard. Under-lift and over-lift transactions might therefore be outside the scope of the standard. Entities will need to make an assessment as to whether an over-lifter is a customer, and this judgement should consider all facts and circumstances including the purpose of the arrangement and transactions.

Even if an over-lifter meets the definition of a customer, transactions might still be outside the scope of the standard because the transaction is a non-monetary exchange between entities in the same line of business. The accounting might therefore differ from the model applied under current guidance if there is no net cash settlement alternative.

New model	Current IFRS
<p>Scope</p> <p>Contractual arrangements that bind the participating parties and specify their entitlement to the output (usually in proportion to each party’s equity interest) are common in the oil and gas industry. These arrangements allow parties to take shares of output in a given period which are different from their entitlement. The contractual arrangement therefore creates an “obligation” for the under-lifter to deliver output to the over-lifter.</p> <p>The obligation would be satisfied and revenue recognised by the under-lifter when the output is lifted by the over-lifter only if the transaction is in the scope of IFRS 15 because:</p> <ul style="list-style-type: none">• the over-lifter 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. <p>If the over-lifter does not meet the definition of a customer or the transaction is a non-monetary exchange, the transaction would be outside the scope of the standard; the under-lifter would not recognise revenue from a contract with a customer (that is, arising for the application of IFRS 15) until it took its share of the output and sold it to a third party in a subsequent period.</p> <p>The under-lifter 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.</p>	<p>Revenue from the sale of goods is recognised when the conditions within paragraph 14 of IAS 18, “Revenue”, are satisfied. These include the transfer of the significant risks and rewards of ownership and ability to measure the amount reliably. The over-lift is currently accounted for by the under-lifter as a sale at the point of lifting.</p> <p>Arrangements generally provide the participants with an entitlement to a share of production in the period and to a share of the remaining reserves. In most cases, such arrangements permit the parties to settle the over-lift position at a point in time in cash, which supports the recognition of a “sale” by the under-lifter rather than an “exchange” by the under-lifter of the current entitlement for an increased share of future entitlement.</p>

Management would need to determine where in the income statement to recognise the credit. The credit would not be recorded within revenue from contracts with customers, as it is outside the scope of the standard. However, it might be recognised as other revenue or other income.

Settlement of the IFRS 9 receivable would occur when the under-lifter takes their entitlement in the next period. The receivable is derecognised, and the debit recognised as inventory if the output is retained or cost of sales if sold to customers.

The over-lifter would recognise revenue when it delivered the output it actually lifted to its customers.

Determining the transaction price

Settlement by the over-lifter to the under-lifter is usually made via a change in the lifting schedule, which allows the under-lifter to take additional liftings in the future.

Where the over-lifter meets the definition of a customer, and the transaction is not a non-monetary exchange between entities in the same line of business, the additional liftings will be “non-cash consideration”, which will be measured at fair value.

The sale of output by the under-lifter to the over-lifter is currently recognised at fair value at the date of lifting.

The extent of under-lift by a party is reflected as an asset in the balance sheet. The under-lift asset is the right to receive additional output from future production without an obligation to fund the production of that additional output. The initial measurement is at the market price at the date of lifting.

Subsequent measurement depends on the contract. Contracts that allow net settlement fall within the scope of IFRS 9 (unless the own-use exemption applies) and are remeasured at the current market price of the output at the balance sheet date. Those outside the scope of IFRS 9 are measured at the lower of carrying amount and current market value. Subsequent remeasurements are included in other income/expense rather than revenue.

Potential impact

If an over-lifter does meet the definition of a customer, the accounting and presentation for the transaction will be similar to current IFRS unless the transaction is a non-monetary exchange. When determining the transaction price, the standard requires that non-cash consideration is measured at fair value.

If an over-lifter does not meet the definition of a customer, the accounting and presentation for an under-lift might be different from current practice. The entity should use judgement in selecting an accounting policy that is relevant and reliable. If the transaction is not a non-monetary exchange, this accounting policy might reflect the principles of the new revenue standard. However, an entity should ensure that any income classified as revenue is consistent with the definition of revenue in the Framework.

If the transaction is a non-monetary exchange, the accounting should be based on other guidance, such as IAS 16, *Property, Plant and Equipment*.

Where the over-lifter does not meet the definition of a customer or the transaction is a non-monetary exchange, but the under-lifter recognises a receivable in the scope of IFRS 9, they will need to recognise the receivable at fair value.

If there is no receivable in the scope of IFRS 9, the entity is likely to use an alternative approach and not deplete its PP&E for the volume relating to the under-lift.

Agency relationships

Oil and gas entities will often engage in other activities in addition to selling extracted hydrocarbons, such as providing transportation of product. It is important to identify whether an oil and gas entity is acting as a principal or an agent in transactions as it is only when the entity is acting as a principal that it will be able to recognise revenue based on the gross amount received or receivable in respect of its performance under a sales contract. Entities acting as agents do not recognise revenue for any amounts received from a customer to be paid to the principal. Revenue is recognised for the commission or fee earned for facilitating the transfer of goods and services. Whether the entity is acting as agent or principal depends on the facts of the relationship, which can require significant judgement.

New standard	Current IFRS
<p>Principal versus agent considerations</p> <p>An entity is the principal in an arrangement if it obtains control of the goods or services of another party in advance of transferring control of those goods or services to the customer.</p> <p>Obtaining title momentarily before transferring a good or service to a customer does not necessarily constitute control.</p> <p>An entity is an agent if its performance obligation is to arrange for another party to provide the goods or services.</p> <p>Indicators that the entity is an agent include:</p> <ul style="list-style-type: none">• the other party is primarily responsible for fulfilment of the contract;• the entity does not have inventory risk;• the entity does not have latitude in establishing prices;• the entity does not have customer credit risk; and• the entity's consideration is in the form of a commission. <p>An agent recognises revenue for the commission or fee earned for facilitating the transfer of goods or services. Its consideration is the 'net' amount retained after paying the principal for the goods or services that were provided to the customer.</p>	<p>The indicators that an entity is acting as principal are that the entity:</p> <ul style="list-style-type: none">• has a contractual relationship with the customer – that is, the customer believes it is doing business with the principal;• is able to set the terms of the transactions, such as selling price and payment terms;• bears the risk associated with inventory; and• bears the credit risk. <p>An indicator that an entity is an agent is if the entity earns a pre-determined fee.</p>

Potential impact

The indicators under the new standard are similar to the existing guidance but are provided in a new context. The indicators are designed to help entities determine if they obtain control of the goods or services before transferring control of those goods or services to the customer. The judgements related to determining whether the company is acting as a principal or agent appear to be increasing within the industry, particularly in relation to companies that provide value-added services to companies that extract oil and gas such as transportation and distribution.

Delivery – Cost, insurance and freight versus free on board

An entity will recognise revenue when (or as) a good or service is transferred to the customer and the customer obtains control of that good or service. Control of an asset refers to an entity's ability to direct the use of and obtain substantially all of the remaining benefits (that is, the potential cash inflows or savings in outflows) from the asset.

Resources are often extracted from remote locations and require transportation over great distances. Transportation by ship might take an extended period of time and be a significant cost. There are two main variants of contracts that address future shipping costs – cost, insurance and freight (CIF) or free on board (FOB).

CIF contracts mean that the selling entity will have the responsibility to pay the costs, insurance and freight until the goods reach a final destination, such as a refinery or an end user. FOB contracts mean that the selling entity delivers the goods when the goods are delivered to an independent carrier. The buyer has to bear all costs and risk of loss to the goods from that point.

In both approaches, contractual terms mean that risk and title and therefore control of the commodity normally pass at the ship's rail. However, the timing of revenue recognition could change under the new standard, depending on the terms of trade. The difference between the shipping terms only affects which party is responsible for freight costs.

Cost, insurance and freight (CIF)

New standard	Current IFRS
<p>Identifying separate performance obligations The new standard will require an entity to account for each distinct good or service as a separate performance obligation. Freight services may meet the definition of a distinct service.</p> <p>Satisfaction of performance obligations An entity recognises revenue when it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains control of that good or service. The new standard lists indicators of control transferring, including an unconditional obligation to pay, legal title, physical possession, transfer of risk and rewards and customer acceptance.</p> <p><i>Sales of goods:</i> Revenue is recognised at the point when control transfers to the customer. This will generally follow the terms of the contract and is usually when the goods pass the rail on a vessel selected by the buyer, at which point the buyer will control the goods.</p> <p><i>Transportation:</i> A performance obligation for transportation generally meets the criteria for a performance obligation that is settled over a period of time, and revenue will be recognised over the period of transfer to the customer. If it does not meet the criteria, the performance obligation would be settled at a point in time, and revenue would likely be recognised when the customer receives the goods.</p>	<p>IAS 18 focuses on whether the entity has transferred to the buyer the significant risks and rewards of ownership of the goods as a key determination of when revenue should be recognised.</p> <p>Industry practice has been for the transfer of significant risks and rewards of ownership to occur when the goods have passed the ship's rail, even if the seller is still responsible for insuring the goods in-transit on the buyer's behalf. A full understanding of the terms of trade is required to ensure that this is the case.</p>

Potential impact

The new standard is generally not expected to change the point at which revenue is recognised for the performance obligation to provide goods. However, when an entity is responsible for organising or executing the shipping, it should evaluate whether it has separate performance obligations for the goods and the freight services. This could mean recognition of a portion of the revenue when control of the goods passes and recognition over time for the portion of revenue relating to the freight services. Where freight services are considered to be a separate performance obligation, the entity should also assess whether it is acting as agent or principal, as this might also affect the timing and amount of revenue recognition.

Factors which might indicate there is a separate performance obligation for transportation include:

- Specialism of any vehicles or technology involved with providing the transportation;
- Level of cost, distance or time associated with providing the transportation; and
- Whether the terms of the contract allow the customer to opt out of the transportation element and collect the commodity themselves.

There cannot be a separate performance obligation for an entity to transport its own goods (that is, prior to transfer of control of the goods to the customer).

Recent developments

The accounting for shipping and handling services is under discussion by the FASB and IASB. The FASB recently proposed a 'practical expedient' that provides U.S. GAAP preparers with an option to account for shipping and handling as a fulfilment cost, rather than as a promised good or service, when shipping and handling occurs after control has transferred to the customer. The IASB has not proposed a similar expedient but will perform further outreach with IFRS stakeholders to identify whether this is an issue. Preparers should monitor developments in those discussions, and consider the impact on accounting.

Example – Timing of revenue recognition in a CIF arrangement

Facts: The entity's revenue contracts are on a CIF basis. Crude oil is transported by pipeline from an offshore operation to the port where it is loaded on tanker to be sent to a refinery in Asia. The refiner is the customer. The entity receives a provisional payment of 90% of the invoice raised 10 days after the crude oil has been unloaded from the ship at the purchaser's facility. The contracts contain a clause that states that the title of the crude oil passes on unloading the goods at the purchaser's facility.

Discussion: The revenue contract is on CIF terms; the seller therefore has to pay the costs, freight and insurance associated with shipping. There is also a specific clause that states that risk and title, and therefore control of the crude oil, only passes on unloading at the purchaser's facility. Revenue would be recognised at the date of unloading. This illustrates the importance of understanding the terms of trade in the contract, as this is what will determine the accounting. Shipping is not a separate performance obligation when an entity controls the goods until they are unloaded.

Free on board (FOB)

New standard	Current IFRS
<p>Satisfaction of performance obligations An entity recognises revenue when it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains control of that good or service.</p> <p>The new standard lists indicators of control transferring, including an unconditional obligation to pay, legal title, physical possession, transfer of risk and rewards and customer acceptance.</p>	<p>IAS 18 focuses on when the entity has transferred to the buyer the significant risks and rewards of ownership of the goods.</p> <p>FOB contracts often stipulate that the purchaser will assume the risk of loss upon delivery of the product to an independent carrier and it is the purchaser's responsibility to pay for any freight or insurance costs beyond that point. The point at which the goods have passed to the independent carrier is usually the point at which the transfer of significant risks and rewards of ownership is considered to have occurred. This is because the seller has no further obligations at that point.</p>

Potential impact

The new standard is generally not expected to change the point at which revenue is recognised for the performance obligation to provide goods. However, an entity should evaluate whether they have a separate performance obligation for the freight services. This could mean recognition of a portion of the revenue when control of the goods passes and recognition over time for the portion of revenue relating to freight services.

Example – Timing of revenue recognition in an FOB arrangement

Facts: The entity's revenue contracts are on FOB basis. Crude oil is transported by pipeline from an offshore operation to the port, where it is loaded on a tanker of an independent carrier to be sent to a refinery in Asia. The refiner is the customer.

The entity receives a provisional payment of 90% of the invoice raised 10 days after the crude oil has been unloaded from the ship into the destination port. The customer's obligation to pay arises when the crude oil passes the rail on loading.

Discussion: The revenue contract is on FOB terms; the control of the crude oil transfers at the moment that it passes the ship's rail on loading, demonstrated by title, physical possession and an obligation to pay, passing to the buyer. As a result, revenue would be recognised upon delivery to the carrier.

Provisional pricing arrangements

Sales contracts for commodities often incorporate provisional pricing. Provisional pricing might arise for a variety of reasons:

- The time taken to transport the product might mean that the customer wishes to pay the market price at the date of eventual delivery at the final destination – in those situations, a provisional price is charged on the date control of the product initially transfers. The final price is generally an average market price for a particular future period or a final assayed amount.
- The product is being transported in unrefined form and the final quality of component commodities will not be known until further assessment at its final destination.

New standard	Current IFRS
<p>Satisfaction of performance obligations The sales contract would be in the scope of the new standard. There will be a single performance obligation, being the delivery of the promised product. Revenue will be recognised when the performance obligation is satisfied, which is when the customer obtains control of the product.</p> <p>Determining the transaction price The entity will need to determine the transaction price, which is the amount of consideration it expects to be entitled to in the transaction.</p> <p>Management should first consider whether provisionally priced contracts include embedded derivatives that are in the scope of financial instrument guidance. An oil and gas entity will apply the separation and/or measurement guidance in other standards first, and then apply the guidance in the revenue standard to the remaining portion of the contract.</p> <p>The transaction price might be variable or contingent on the outcome of future events, which could include provisional pricing arrangements.</p> <p>Variable consideration is subject to a constraint. The objective of the constraint is that an entity should recognise revenue as performance obligations are satisfied to the extent that it is “highly probable” that a significant revenue reversal will not occur in future periods. Such a reversal would occur if there is a significant downward adjustment of the cumulative amount of revenue recognised for that performance obligation.</p> <p>Judgement will be required to determine if there is an amount that is variable consideration and if so, whether it is subject to a significant reversal. The new standard has a list of factors that could increase the likelihood or magnitude of a revenue reversal.</p> <p>Management’s estimate of the transaction price will be reassessed each reporting period.</p>	<p>Revenue from the sale of provisionally priced commodities is recognised when the risks and rewards of ownership are transferred to the customer, which is generally the date of delivery.</p> <p>Revenue is measured based on the forward market price of the commodity or estimates of the quality of unrefined product at the date title passes.</p> <p>Where a future market price is to be used to settle a contract, at each subsequent period end the provisionally priced contracts are marked to market using the most up-to-date market prices with any resulting adjustments usually being recognised within revenue.</p> <p>Where the initial revenue recognition is based on estimates of the quality of the product, an adjustment is made when the product is delivered and the final quality is known. Many entities recognise this adjustment in revenue.</p>

Potential impact

Judgement will be required to determine if the provisional pricing results in the identification of an embedded derivative or variable consideration. If the entity determines that the provisional pricing results in variable consideration, further judgement will be required to determine whether the estimated transaction price is subject to significant reversal. This might be particularly relevant where the final quality of product being delivered will not be known until assessment at its destination. Where price is conditional upon the quality of the product, this is more likely to be variable consideration.

Judgement will also be required to identify the point at which the variable consideration becomes unconditional, and is then considered a financial asset within the scope of IFRS 9/IAS 39.

Where provisional pricing features represent embedded derivatives, oil and gas entities would be required to continue to separate them and recognise and measure them in accordance with financial instrument guidance. However, given the revised presentation requirements in the new standard, it may no longer be appropriate to present movements in the embedded derivative in revenue from contracts with customers.

Example – Provisional pricing

Facts: An entity enters into a contract to sell 200,000 barrels of crude oil to a customer on 1 December 20X4. The final price will be based on the Brent Crude Oil Futures price three months from the date of delivery.

Delivery takes place on 31 December 20X4 and control of the oil is transferred to the customer on that date. Final invoicing will take place on 31 March 20X5. The entity has a 31 December year-end.

The three-month forward oil price on 31 December is \$62 per barrel. On 31 March 20X5 the oil price amounts to \$70 per barrel.

Discussion: At contract inception (1 December 20X4), the entity will need to determine whether the provisional pricing mechanism represents an embedded derivative that needs to be separated from the host sales contract. Revenue will be recognised on 31 December 20X4, the date when control of the oil is transferred to the customer and the performance obligation is satisfied. Judgement will be required to identify the point at which the consideration becomes unconditional, and is then a financial asset within the scope of IFRS 9/IAS 39.

If the entity concludes that the provisional pricing is variable consideration and not a financial asset within the scope of IFRS 9/IAS 39, the entity would need to apply judgement in:

- estimating the variable sales price at 31 December 20X4; and
- determining whether the estimate meets the “highly probable” test regarding the likelihood of significant reversal.

It should be highly probable that the revenue would not be subject to a significant revenue reversal between 31 December 20X4 and 31 March 20X5. To the extent the entity were to report results on 31 January 20X5, before the final invoicing on 31 March 20X5, the estimate of the transaction price and revenue constraint would need to be reassessed.

Take-or-pay and similar long-term supply agreements

Long-term sales contracts are common in the oil and gas industry. Producers and buyers may enter into sales contracts that are often a year or longer in duration to secure supply and reasonable pricing arrangements. Such contracts are often fundamental to supporting the business case or to finance, develop or continue activity at a particular field.

Contracts will typically stipulate the sale of a set volume of product over the period at an agreed price. There are often clauses within the contract relating to price adjustment or escalation over the course of the contract to protect the producer and/or the seller from significant changes to the underlying assumptions in place at the time the contract was signed. Long-term commodity contracts frequently offer the counterparty flexibility and options in relation to the quantity of the commodity to be delivered under the contract.

Oil and gas entities should continue to first assess whether these arrangements represents financial instruments or contain embedded derivatives that should be accounted for under the financial instruments standards (e.g., whether a contract with volume flexibility contains a written option that can be settled net in cash or another financial instrument). In addition, oil and gas entities should continue to evaluate whether such arrangements convey the right to use a specific asset, and therefore constitute a lease under the leasing standards.

New standard	Current IFRS
<p>Identifying the contract</p> <p>In relation to take-or-pay contracts, only the minimum amount specified would generally be considered a contract, as this is the only enforceable part of the agreement. Options in the contract to acquire additional volumes will likely be considered a separate contract at the time the customer exercises the option, unless such options provide the customer with a material right (e.g., an incremental discount). Where there is a material right, the option should be accounted for as a separate performance obligation in the original contract.</p> <p>It is likely that each unit of product will be considered a separate performance obligation (e.g., barrel of crude oil). This will require the total transaction price to be allocated to the separate performance obligations using standalone selling prices.</p> <p>Breakage</p> <p>Customers may not exercise all of their contractual rights to receive a good or service in the future. Unexercised rights are often referred to as breakage.</p> <p>An entity should recognise estimated breakage as revenue in proportion to the pattern of exercised rights. Management might not be able to conclude whether there will be any breakage, or the extent of such breakage. In this case, they should consider the constraint on variable consideration, including the need to record any minimum amounts of breakage. Breakage that is not expected to occur should be recognised as revenue when the likelihood of the customer exercising its remaining rights becomes remote. The assessment should be updated at each reporting period.</p> <p>In take-or-pay arrangements, this may mean that an entity</p>	<p>Revenue is recognised when the volumes of the product concerned, e.g., crude oil, are delivered and they are typically measured at market price or fixed price (as specified in the contract).</p> <p>Revenue related to volumes not taken, but paid for, is generally recognised at the end of the stated take-or-pay period if the customer is not able to make-up volumes in future take-or-pay periods. If the customer is entitled to make-up volumes in future take-or-pay periods, revenue is recognised either when the payment is applied to future volumes, or the right to make-up volumes expires.</p>

may be able to recognise revenue in relation to breakage amounts in a period earlier than when the breakage occurs, provided that it can demonstrate it expects that the customer will not exercise these rights. Given the nature of these arrangements and the inherent uncertainty in being able to predict a customer's behaviour, it may be difficult to satisfy this requirement.

Potential impact

The new standard will require oil and gas entities to apply judgement in identifying the performance obligations, as well as the reasons for any price changes over the term of the arrangement. These judgements will determine whether the total transaction price is allocated and recognised based on stand-alone selling prices (e.g., using forward curves), contractual pricing, straight line or another basis. Oil and gas entities will also have to consider whether such arrangements include a significant financing component that will have to be accounted for separately (see [In depth INT 2014-02](#) for more details).

Recent developments

It is under discussion by the TRG whether commodities might fit into the "series of distinct goods or services" guidance. See [In Transition US 2015-06](#) for further details.

Disclosures

The revenue standard includes a number of extensive disclosure requirements intended to enable users of financial statements to understand the amount, timing, and judgements related to revenue recognition and corresponding cash flows arising from contracts with customers. We highlight below some of the more significant disclosure requirements, but the list is not all-inclusive.

The disclosures include qualitative and quantitative information about:

- contracts with customers;
- the significant judgements, and changes in judgements, made in applying the guidance to those contracts; and
- assets recognised from the costs to obtain or fulfil contracts with customers.

The standard requires disclosures that disaggregate revenue into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. The standard contains guidance on how to select categories.

The disclosure requirements are more detailed than currently required under IFRS and focus significantly on the judgements made by management. For example, they include specific disclosures of the estimates used and judgements made in determining the amount and timing of revenue recognition.

The new standard also requires an entity to disclose the amount of its remaining performance obligations and the expected timing of the satisfaction of those performance obligations for contracts with durations of greater than one year, and both quantitative and qualitative explanations of when amounts will be recognised as revenue. This requirement could have a significant impact on the oil and gas industry, where long-term contracts are a significant portion of an entity's business.

Final thoughts

The above discussion does not address all aspects of the new standard. Companies should continue to evaluate how the new standard might change current business activities, including contract negotiations, key metrics (including debt covenants, surety, and prequalification capacity calculations), taxes, budgeting, controls and processes, information technology requirements, and accounting.

Entities are encouraged to monitor the discussions of the TRG. The TRG was established in 2014 to help the FASB and the IASB determine whether more implementation guidance is needed. The TRG will make no formal recommendations to the boards' or issue any guidance. Any views discussed by the TRG will be non-authoritative.

Entities will be required to apply the new revenue standard in the first interim period within annual reporting periods beginning on or after and 1 January 2017. Earlier adoption is permitted.

The IASB agreed at their meeting on 22 July 2015 to a deferral of the effective date of the new standard by one year until 1 January 2018. The option for entities to early adopt the standard will remain.

Entities can adopt the final standard retrospectively or use a simplified approach. Entities using the simplified approach will: (a) apply the revenue standard to all existing contracts as of the effective date and to contracts entered into subsequently; (b) recognise the cumulative effect of applying the new standard in the opening balance of retained earnings on the effective date; and (c) disclose, for existing and new contracts accounted for under the new revenue standard, the impact of adopting the standard on all affected financial statement line items in the period the standard is adopted. An entity that uses this approach must disclose this fact in its financial statements.

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Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner.

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