

VIEWPOINTS:

Applying IFRSs in the Oil and Gas Industry

PRESENTATION OF TRANSPORTATION COSTS

JULY 2016

Background

Oil and gas commodities are often extracted in remote locations and require transportation. Some producers may sell their commodity at the wellhead, processing facility, or pipeline inlet; others may transport or engage a third-party intermediary (i.e., a shipping company) to carry the commodity to the purchaser (i.e., customer).

Transportation costs may be paid by the producer. In other instances, transportation costs may be paid by the purchaser and, in some cases, subsequently reflected as an adjustment or offset to the price paid to the producer. This adjustment is often referred to as a “notional location difference”, which is the difference between the price at the delivery point (i.e., the point where the commodity is transferred to the purchaser) and the market where the product is priced (i.e., a designated market sales hub).

For example, the market sales price for a barrel of crude oil is \$50 at location X, a designated market sales hub. The producer produces this particular barrel of crude oil at location A (a location that is not a designated market sales hub). The cost of transporting oil between location A and X is \$10. This document will explore circumstances when the producer recognizes \$50 of revenue and a transportation expense of \$10 within the statement of profit or loss, and circumstances when the producer recognizes \$40 of revenue with no associated transportation expense.

Oil and Gas Industry Task Force on IFRSs

International Financial Reporting Standards (IFRSs) create unique challenges for junior oil and gas companies. Financial reporting in the sector is atypical due to significant differences in characteristics between junior oil and gas companies and other types of companies. The Canadian Association of Petroleum Producers (CAPP), the Explorers and Producers Association of Canada (EPAC) and the Chartered Professional Accountants of Canada (CPA Canada) created the Oil and Gas Industry Task Force on IFRSs to share views on IFRS application issues of relevance to junior oil and gas companies. The task force views are provided in a series of papers that are available through free download. These views are of particular interest to Chief Financial Officers, Controllers and Auditors.

The views expressed in this series are non-authoritative and have not been formally endorsed by CAPP, EPAC, CPA Canada or the organizations represented by the task force members.

Issue

In what circumstances should transportation cost be netted from revenue or presented as a separate expense by a producer?

Viewpoints

Whether the producer recognizes \$50 of revenue and \$10 of transportation expense or whether the producer recognizes \$40 of revenue without showing a transportation expense will depend on the specific facts and circumstances discussed below.

Revenue is measured at the fair value of the consideration received or receivable. The location where a commodity is sold can impact its fair value. This is clarified by IFRS 13.26:

If location is a characteristic of the asset (as might be the case, for example, for a commodity), the price in the principal (or most advantageous) market shall be adjusted for the costs, if any, that would be incurred to transport the asset from its current location to that market.

For oil and gas, location is generally a characteristic of the price of the asset. For example, oil delivered at a wellhead may have a lower price than oil delivered at a location with an active market (e.g., designated market sales hub).

When considering the presentation of revenue and as a consequence the associated transportation costs (if any), an oil and gas entity analyzes where the significant risks and rewards of ownership transfer to the purchaser under IAS 18 *Revenue*. In a straightforward sale, risks and rewards of ownership to a barrel of oil often transfer to a purchaser when title to the barrel of oil transfers.

An oil and gas entity should also assess its revenue arrangements against specific criteria in order to determine whether it is acting as principal or agent. Example 21 in the Illustrative Examples accompanying IAS 18 includes guidance to help determine whether an entity is acting as a principal or as an agent. The list of features in Example 21 is not intended to be exhaustive.

Accounting by Producer without Transportation Commitments

When a producer has no transportation commitment because the transportation of the product is the responsibility of the purchaser, the producer generally does not present transportation expense for the associated sale.

In certain instances, a purchaser may agree to pay for the product net of a transportation cost. This adjustment may reflect a notional transportation cost (see “Background” section above) or an actual transportation cost incurred by the purchaser to transport the product. Since the producer is not responsible for transportation (i.e., the producer is not the principal

in the transportation arrangement), the producer presents revenue at the net amount received from the purchaser (i.e., reflecting the value of the product at the point of sale) and no transportation expense for the associated sale.¹

For example, the market sales price for a barrel of crude oil is \$50 at location X, a designated market sales hub. The producer produces this particular barrel of crude oil at location A (a location that is not a designated market sales hub). The purchaser agrees to acquire the noted barrel of crude oil from location A and pays the producer \$40/barrel. The producer does *not* have a transportation commitment. In this case, assuming no other pricing considerations except location, the \$10 difference between the market sales price and the agreed transaction price is associated with the location difference. Accordingly, in this example, the producer recognizes \$40 of revenue with no associated transportation expense.

Accounting by Producer with Transportation Commitments

When a producer has a transportation commitment, the producer generally presents the associated transportation expense for the associated sale. A producer that has a transportation commitment is generally the principal in the arrangement with the transportation company, unless it has been released on an absolute basis from this commitment (discussed further below). In practice, a transportation commitment may arise either directly with the transportation company or be the result of a firm commitment for transportation with the purchaser or a marketing agent.

When the producer has a transportation commitment, generally there are two scenarios:

1. Title to the product has passed to the purchaser after transportation

When title to the product has passed to the purchaser *after* transportation, the purchaser has enhanced the value of its product by transporting it to a sales location (e.g., a designated market sales hub).

For example, the market sales price for a barrel of crude oil is \$50 at location X, a designated market sales hub. The producer produces this particular barrel of crude oil at location A (a location that is not a designated market sales hub). The purchaser agrees to acquire the noted barrel of crude oil from location X and pays the producer \$50/barrel. The producer has a transportation commitment to deliver the oil to location X; title to the oil passes to the purchaser after transportation. In this case, because the producer is a principal in the transportation arrangement, the transportation costs for the associated sale is presented by the producer and not netted against revenue. Accordingly, in this example, the producer recognizes \$50 of revenue and an associated transportation expense at its cost of transporting the oil to location X.

¹ Under IAS 18.14, one of the criteria for recognizing revenue is that “the entity has transferred to the customer the significant risks and rewards of ownership of the goods”.

Example 21 in the Illustrative Examples accompanying IAS 18 includes guidance to help determine whether an entity is acting as a principal or as an agent. The list of features in Example 21 is not intended to be exhaustive. An entity is acting as a principal when it has exposure to significant risk and rewards associated with the sale of goods or rendering of services. A principal to the arrangement records revenue at the gross amount; an agent to the arrangement records revenue at the net amount.

2. Title to the product has passed to the purchaser prior to transportation

When title to the product has passed to the purchaser *prior* to transportation, the transaction may be considered a multiple-element arrangement (i.e., the purchaser may be acquiring the product and also purchasing transportation services from the producer).

In such an arrangement, separate presentation of revenue may occur for the sale of the product and the sale of transportation services. However, when the product is transported soon after it is extracted, the timing of revenue recognition for the separate elements is typically not a significant issue. In such cases, it is common practice to present combined revenue, reflecting the sale of the product and sale of transportation services.

For example, the market sales price for a barrel of crude oil is \$50 at location X, a designated market sales hub. The producer produces this particular barrel of crude oil at location A (a location that is not a designated market sales hub). The purchaser agrees to acquire the noted barrel of crude oil from location A and requires it to be transported to location X. The purchaser pays the producer \$50/barrel. Title to the oil passes to the purchaser prior to transportation. However, the producer committed to transport the oil to location X. In this case, because the producer is a principal in the transportation arrangement, the transportation expense for the associated sale is presented by the producer. Accordingly, in this example, the producer recognizes \$50 of revenue (representing the combined sale of product and transportation services) and an associated transportation expense at its cost of transporting the oil to location X.

Release or Assignment of Transportation Commitments

Release

In some cases, a producer may sign a transportation commitment but later be released by the transportation company from its obligations under the arrangement in favour of a purchaser or other party (i.e., the producer is no longer subject to any obligation to the transportation company even when the purchaser or other party becomes insolvent).

When the producer has been released by the transportation company, the producer will normally take the position that it does not have a transportation commitment for the released amount and will consider the guidance for “Accounting by Producer without Transportation Commitments” above.

Assignment

In other cases, a producer with a signed transportation commitment may have assigned its transportation contract to another party without being released by the transportation company from its commitment (i.e., if the contractual obligations are not fulfilled by the assignee, the obligation reverts to the producer).

In this case, the producer will normally hold the view that it continues to have a transportation commitment and will consider the guidance for “Accounting by Producer with Transportation Commitments” above.

IFRS 15 Revenue from Contracts with Customers

In 2014, the IASB issued IFRS 15 *Revenue from Contracts with Customers*, setting out a new, single, comprehensive framework for revenue recognition. IFRS 15 replaces all current revenue standards and interpretations in IFRS, including IAS 18 *Revenue* and is effective for annual reporting periods beginning on or after January 1, 2018 (earlier application is permitted).² Oil and gas entities will need to consider how the new standard might affect their accounting and disclosure.

To determine the appropriate accounting for transportation costs under IFRS 15, oil and gas entities are encouraged to study IFRS 15 and to monitor international developments affecting the application as it relates to the guidance on principal versus agent as well as the guidance on identifying separate performance obligations.

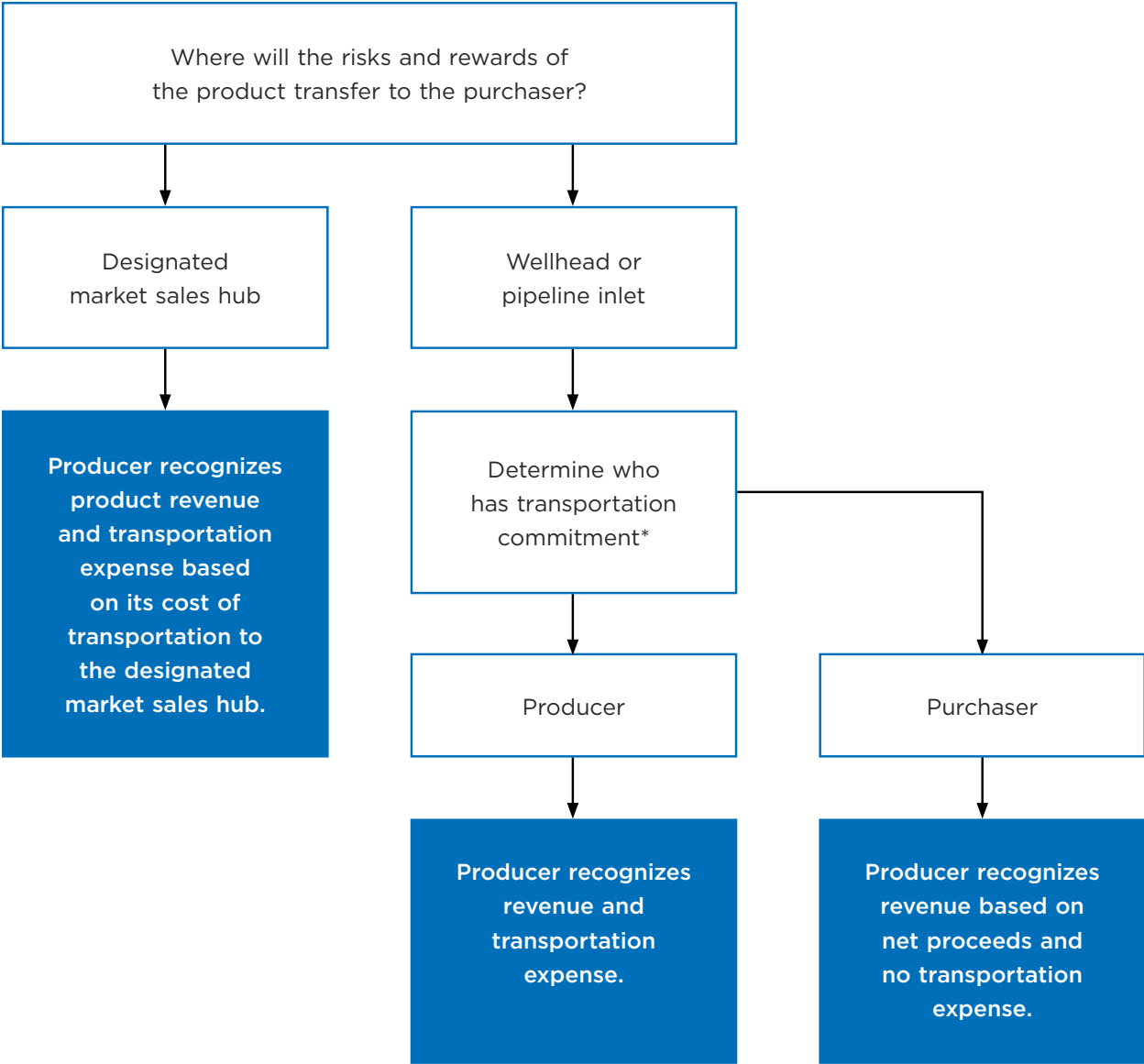
Depending on the facts and circumstances, IFRS 15 may affect the identification of performance obligations and the allocation of revenue to those performance obligations. For example, a transportation commitment subsequent to control of the product transferring to the customer may be a separate performance obligation and require a portion of the transaction price to be allocated to that separate performance obligation at an amount equivalent to its relative stand-alone selling price. IFRS 15 also provides additional guidance on the disaggregation of revenue streams and expands disclosure requirements for separate performance obligations.

As implementation of IFRS 15 develops, this *Viewpoints* may be updated.

² To learn more about IFRS 15, visit the CPA Canada website at www.cpacanada.ca/ifrs.

Appendix

Illustrative Decision Tree: Accounting by Producer for Transportation Costs



*If producer is “released” from its transportation commitment, the producer would generally take the position that it does not have a transportation commitment. If the producer “assigns” its transportation commitment, the producer will usually recognize that it continues to have a transportation commitment.

The Oil and Gas Industry Task Force on IFRSs

Members

Kevin Hamm, CPA, CA (Chair)

Canadian Natural Resources Limited
Calgary, Alberta

Steve Aubin, CPA, CA

Deloitte & Touche LLP
Calgary, Alberta

Scott Bandura, BMath, MAcc, CPA, CA, CPA (Illinois, USA)

PricewaterhouseCoopers LLP
Calgary, Alberta

Brad Bennett, CPA, CA

Vermilion Energy Inc.
Calgary, Alberta

Kara Mah, CPA, CA

Grant Thornton LLP
Calgary, Alberta

Kerry Clark, CPA, CA

Ernst & Young LLP
Calgary, Alberta

Jeff Dashkin, CPA, CA

Calgary, Alberta

Sean Du Plessis, CPA, CA

MNP LLP
Calgary, Alberta

Steven Glover, MBA, FCPA, FCA

Canmore, Alberta

Katherine Gomes, CPA, CA

ARC Resources Ltd.
Calgary, Alberta

Imam Hasan, CPA, CA

KPMG LLP
Calgary, Alberta

Adrienne Viala, CPA, CA

Husky Energy Inc.
Calgary, Alberta

Lorraine L. Walker, CPA, CA

BDO Canada LLP
Calgary, Alberta

Observer

Janice Anderson, CPA, CA

Alberta Securities Commission
Calgary, Alberta

Staff

Ben Brunnen

Canadian Association of Petroleum Producers
Calgary, Alberta

Gary Leach

Explorers and Producers Association
of Canada
Calgary, Alberta

Rosemary McGuire, CPA, CA

Chartered Professional Accountants
of Canada
Toronto, Ontario

Comments on this *Viewpoints* or suggestions for future *Viewpoints* should be sent to:

Rosemary McGuire, CPA, CA

Principal, Reporting & Capital Markets

Research, Guidance and Support

Chartered Professional Accountants of Canada

277 Wellington Street West

Toronto, Ontario M5V 3H2

email: rmcguire@cpacanada.ca

For more information on IFRSs visit:

www.cpacanada.ca/viewpointsoilgas