

IFRS Developments

Sale of output by a joint operator

What you need to know

- ▶ The IFRS IC has 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 IFRS IC issued an agenda decision in March 2019 concluding 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 the joint operator only recognises revenue for the output that it has sold to the customer, regardless of what output the joint operator is entitled to.

Highlights

During the implementation of IFRS 15 *Revenue from Contracts with Customers*, the IFRS Interpretations Committee (the IFRS IC or the Committee) was asked 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.

In March 2019, the IFRS IC issued an agenda decision concluding that, in the fact pattern described, 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, for example, the joint operator does not recognise revenue for the output to which it is entitled, but that it has not received from the joint operation and sold.

The Committee concluded that the principles and requirements in 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 as described in the request. Consequently, the Committee decided not to add this matter to its standard-setting agenda.

The Committee discussed, in November 2018 (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 agenda decision does not address this. We recommend that entities disclose the accounting treatment adopted for the expenditures recognised in cost of goods sold during a reporting period, including the assumptions used and judgements made.

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, classified as a joint operation under IFRS 11, by entering into a joint operating agreement (JOA)
- ▶ The JOA specifies that 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 its proportionate share of the production costs incurred
- ▶ The imbalance that arises will be settled through future deliveries of output.

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.¹ 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.² This is consistent with the Basis for Conclusion to IFRS 15,³ 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".⁴

¹ IFRS 15.31.

² IFRS 15.5(d), 6.

³ IFRS 15.BC52-BC56.

⁴ IFRS 11.21, IFRS 15 BC52-BC56.

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 the associated revenue recognition.

The agenda decision 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 agenda decision 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 provision for, 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 adjustment is considered to record either: 1) a prepayment or provision 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 of, or provision for, 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 the joint operator's gross margin reflecting the gross margin that would be earned based on its entitlement interest. If an adjustment were recorded through cost of goods sold at cost, the gross margin shown would reflect the gross margin attributed to the volumes actually sold to customers.

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.

We anticipate that diversity will continue with respect to the measurement of adjustments made to cost of goods sold for the difference between the cost of the output to which the joint operator is entitled and the cost of the output actually lifted and sold.

Entities should disclose the accounting treatment adopted in respect of this matter, including judgements and assumptions in respect of any adjustment recorded to costs of goods sold, to aid comparability between financial reports.

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

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