Applying IFRS in Oilfield Services

IASB – proposed standard

Revised proposal for revenue from contracts with customers

Implications for the oilfield services sector

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Ernst & Young

Quality In Everything We Do

Introduction

The revised proposal in the revenue recognition Exposure Draft (ED) issued by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) could result in significant changes in practice for oilfield services companies, in our view.

The oilfield services sector covers a wide range of value chain segments, including reservoir/seismic; exploration and production drilling; engineering, fabrication and installation; operations (production and maintenance); and decommissioning. The larger entities in this sector tend to provide a wide range of services across the value chain, offering integrated solutions to customers. Smaller entities in this sector typically focus on providing more specific products and services. Therefore, the nature and complexity of the contractual arrangements with customers that entities within this sector enter into can vary significantly.

This publication is an oilfield services sector-specific supplement to the recently issued *Applying IFRS: Revenue from Contracts with Customers – the revised proposal* (January 2012) (the general publication).[1] The general publication summarises the revenue recognition model proposed in the ED issued in November 2011, highlights some issues for entities to consider in evaluating the impact of the ED and discusses some of the changes that are expected to current IFRS.

This supplement highlights some potentially significant implications for oilfield services entities. The impact for the oil and gas sector is considered in a separate publication entitled *Revenue from Contracts with Customers: the revised proposal – impact on the oil & gas sector.*

The issues in this supplement are intended both to provoke thought and to assist entities in formulating ongoing feedback to the Boards. The discussions within this supplement represent our preliminary thoughts, and additional issues may be identified through continued analysis of the ED, as the elements of the ED may change based upon further deliberation by the Boards.

[1] Available on ey.com/ifrs

What you need to know

- The IASB and the FASB issued a revised ED in November 2011
- Applying the proposal would require oilfield entities to evaluate performance obligations at a lower, more detailed level than under current practice
- The proposal may require entities in the oilfield services sector to use different approaches to measure their progress towards the satisfaction of a performance obligation that is satisfied over time
- The proposal will significantly increase the volume of financial statement disclosures

Contents

Scope	4
Construction and manufacturing contracts	5
Day rate drilling contracts	21
Seismic services	22
Data licensing	23
Next steps	23
Ernst & Young Global Oil & Gas center	24

Scope

The scope of the ED relates to revenue from contracts with customers. This will affect all entities that enter into contracts to provide goods or services to their customers (unless those contracts are specifically scoped out of this ED or are in the scope of other IFRSs). Furthermore, the ED outlines the principles an entity would apply to report decision-useful information about the measurement and timing of revenue and the related cash flows. For the oilfield services sector, the primary exclusions from the scope of the ED are lease contracts and financial instruments.

The core principle is that an entity would recognise revenue to depict the transfer of goods or services to customers at an amount that reflects the consideration the entity expects to be entitled in exchange for those goods or services. This is achieved through the application of the following five steps:

1. Identify the contract(s) with a customer
2. Identify the separate performance obligations
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations
5. Recognise revenue when the entity satisfies each performance obligation

In applying these steps, an entity would be required to exercise judgement when considering the terms of the contract(s) and all facts and circumstances, including any implied contractual terms. An entity would also have to consistently apply the requirements of the proposed model to contracts with similar characteristics and in similar circumstances.

Further, the proposed requirements would also apply to the measurement and timing of recognition of gains or losses on the sale of certain non-financial assets, such as property, plant and equipment and intangible assets.

In addition, the ED states that if a contract is partially within the scope of the proposed revenue recognition standard and partially within the scope of another standard, entities would first apply the separation and measurement requirements of the other standard (e.g., accounting for an embedded lease or an embedded derivative). Otherwise, entities would apply the separation and measurement requirements in the proposed revenue recognition standard.

As noted earlier, the oilfield services sector covers a broad range of services and hence a broad range of contract types. We will examine the implications of the ED by considering them as they would apply to construction and manufacturing contracts. We will then consider other common types of arrangements such as drilling contracts, seismic contracts and data licensing, and identify some of the key factors entities will need to consider when assessing the impact of the ED on these contracts. However, entities should consider all of their arrangements with customers to ensure they have identified all potential impacts. Refer to Section 1.1 of our general publication for more details on scope.

How we see it

Given the nature of the arrangements within the oilfield services sector, identifying the customer is not expected to be complex and those contracts currently considered revenue-generating are likely to continue to be within scope.

The current accounting for operating leases and service contracts is often similar. As a result, determining that a service arrangement contains an operating lease generally does not result in significantly different accounting for the arrangement under current accounting standards. Consequently, it is possible that, to date, not all embedded leases have been identified, extracted and accounted for on this basis.

However, under the proposed leasing requirements, the accounting for a lease by the lessor could be significantly different from the accounting for a service arrangement. Therefore, this assessment may have significantly different accounting implications when service contracts are considered to contain embedded leases. This will increase the importance of analysing contracts to determine whether the revenue recognition requirements are applied solely to elements within the scope of the revenue standard.

Construction and manufacturing contracts

The types of construction and manufacturing contracts in this sector can vary significantly, both in type and complexity of the goods and services provided and duration of the contract. We will explore some of the more common aspects of these arrangements and the potential implications of the proposed standard.

Step 1: Identify the contracts with a customer

The first step of the model is to identify the contract, or contracts, to provide goods or services to customers. In general, identifying the contract with the customer would not differ significantly from current practice. For example, the proposed requirements on combining two or more contracts entered into with the same customer at or near the same point in time, into a single contract for accounting purposes is similar with existing practice. As a result, we anticipate that entities would reach conclusions about combining contracts that are similar to today's conclusions. However, there may be some changes from current practice, primarily involving accounting for contract modifications.

Contract modifications

Contract modifications may be common in some types of construction and manufacturing contracts, and potentially more so in the longer term contracts. This could include modifications to change the scope of the contract when the parties have not yet agreed on a price (frequently referred to as unpriced change orders).

Under the ED, contract modifications are defined as changes to the scope of work, the price, or both, that have been approved by both parties to the contract. While the ED indicates that modifications would have to be approved by the parties to the arrangement, it also makes it clear that unpriced change orders would be considered contract modifications and accounted for when the entity has an expectation that the pricing change will be approved.

The ED outlines a number of ways to account for contract modifications, depending on the characteristics of the modification and the underlying arrangements. The alternatives are as follows:

- If the modification changes only the pricing of the promised goods or services, the modification would be treated as a change in the estimated transaction price. Under the ED, a change in estimated transaction price after contract inception would be allocated to the separate performance obligations in the same manner that the initial estimated transaction price was allocated, unless it can be determined that the change relates entirely to one or more distinct goods or services (refer to Illustration 1 below for further detail).
- When a modification changes the scope of an arrangement or the scope and pricing of an arrangement, the modification might be treated as a separate contract. That is, if the modification results in additional distinct goods or services and the promised consideration associated with those goods or services reflects the entity's standalone selling price for those additional goods or services, the additional distinct goods or services and related consideration would be treated as a separate contract.

Illustration 1 – Change in price

A contractor enters into an arrangement to provide customised services to a customer. The contract includes a design phase, a production and delivery phase, and a maintenance phase. The design phase, the production and delivery phase and maintenance phase are considered to be three separate performance obligations (see below in "Step 2: Identify the separate performance obligations" for further discussion on identifying separate performance obligations).

At contract inception, the total transaction price of CU 10,000,000 was allocated to each performance obligation, based on its relative standalone selling price, as follows:

	Standalone selling price	% of total	Contract price	Allocation
Design services	CU 3,000,000	26%	CU 2,000,000	CU 2,600,000
Production and delivery	CU 7,500,000	65%	CU 7,500,000	CU 6,500,000
Maintenance	CU 1,000,000	9%	CU 500,000	CU 900,000
	CU 11,500,000	**100%**	**CU 10,000,000**	**CU 10,000,000**

During the production and delivery phase, due to an increase in anticipated costs, the contractor and the customer agree to increase the price of the overall contract by CU 1,000,000 to compensate the contractor for these additional costs and the associated profit margin.

As this modification represents only a change in price and not a change in the scope of work, and assuming the entity could not demonstrate that the change in price related entirely to any distinct goods or services, the revised transaction price would be allocated to the separate performance obligations based on the standalone selling prices used at contract inception, as follows:

	Standalone selling price	% of total	Revised contract price	Revised allocation
Design services	CU 3,000,000	26%	CU 2,000,000	CU 2,860,000
Production and delivery	CU 7,500,000	65%	CU 8,500,000	CU 7,150,000
Maintenance	CU 1,000,000	9%	CU 500,000	CU 990,000
	CU 11,500,000	**100%**	**CU 11,000,000**	**CU 11,000,000**

The contractor had already completed the design phase and recognised the revenue allocated to that performance obligation (CU 2,600,000), therefore the contractor would need to recognise the additional revenue allocated to this performance obligation to reflect the change in transaction price that was allocated to the design phase (CU 260,000). This amount would be recognised as revenue in the period during which the modification was agreed.

If the contractor had started to recognise revenue related to the production and delivery phase, additional revenue would be recognised on a "cumulative catch-up" basis to reflect the additional progress toward completion in the period in which the modification was agreed.

As noted above, the ED states that when the transaction price changes after contract inception, for example as a result of a contract modification, such a change would ordinarily be allocated across all performance obligations in accordance with the principles explained above. However, an entity would be required to allocate that change in transaction price entirely to one or more distinct goods or services if both of the following criteria were satisfied:

a) The change in the transaction price for the distinct good or service relates specifically to the entity's efforts to transfer that good or service (or to a specific outcome from transferring that good or service)

And

b) The change in transaction price is allocated entirely to the distinct good or service consistent with the allocation principles set out in the ED (when considering all of the performance obligations and payment terms in the contract). For a contract that has more than one performance obligation, the transaction price is to be allocated to each separate performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation.

Illustration 2 — Change in scope and price

A contractor enters into an arrangement to provide production and delivery services and maintenance services to a customer.

At contract inception, the total transaction price of CU 10,000,000 was allocated to each performance obligation, based on its relative standalone selling price. Midway through the production phase, the contractor and customer renegotiate the contract. The contractor agrees to provide additional goods and services for additional consideration of CU 3,750,000.

As the modification results in a change in both the scope and price of the arrangement, the contractor must determine whether the additional goods and services are distinct and also whether the additional consideration is consistent with the standalone selling price for those goods and services. In this scenario, the additional goods and services are distinct because they are regularly sold by the contractor on a standalone basis. Furthermore, the additional consideration payable is consistent with the standalone selling price of these goods and services.

As a result, the additional goods and services and the additional consideration of CU 3,750,000 would be treated as a separate contract. The contractor would not change the accounting for the original contract.

- Contract modifications in which the additional goods or services are not distinct and the promised consideration associated with the additional goods or services does not reflect the standalone selling price would not be treated as separate contracts. Furthermore, contract modifications that modify or remove previously agreed goods and services would also not be treated as separate contracts. An entity would account for the effects of these modifications differently, depending on the situation:

(a) The goods or services not yet provided are distinct from the goods or services provided before the modification — the entity would allocate any consideration not yet recognised as revenue to the remaining separate performance obligations. In effect, this approach would treat the contract modification as a termination of the old contract and the creation of a new contract. While this is not explicitly stated in the ED, we believe that an entity would also have to reflect in the allocation of the revised transaction price, any changes in the standalone selling prices of the remaining goods or services.

(b) All of the promised goods or services are part of a single performance obligation (i.e., the goods or services not yet provided are not distinct from the goods or services provided to date) and that performance obligation is partially satisfied as of the date of the modification — the entity would account for the modification as if it were part of the original contract and would recognise the effect of the modification on a cumulative catch-up basis. This approach would effectively treat the modification as part of the original contract.

(c) If the goods or services not yet provided are a combination of (a) and (b) above — the entity would allocate all remaining consideration to the unsatisfied (including partially unsatisfied) performance obligations. The entity would exclude any completely satisfied performance obligations from this allocation. To perform this reallocation, we believe entities would have to update their estimates of standalone selling price for each separate performance obligation. For performance obligations satisfied over time that are partially satisfied as of the date of the modification/reallocation, the entity would update the measure of progress based on any changes in the performance obligations and allocated transaction price on a cumulative catch-up basis.

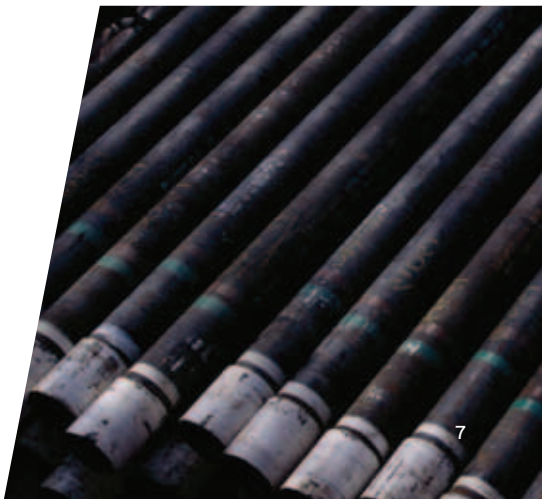

Illustration 3 – Change relates to a single performance obligation

A contractor enters into an arrangement with a customer to provide design and implementation services. There is a design phase and an implementation phase across 20 locations for total consideration of CU 4,800,000. The design phase is scheduled to last 18 months, and the implementation phase will occur over the following 18 months. Total costs for design and implementation are expected to be CU 3,400,000.

Assume that the contractor determines that it has a single performance obligation (see "Step 2: Identify the separate performance obligations" below for further discussion) and that the performance obligation is satisfied over time, based on the criteria for continuous revenue recognition (see "Step 5: Satisfaction of performance obligations – recognising revenue"). In addition, assume the contractor determines that a cost-to-cost approach best depicts its measure of progress toward satisfaction of the performance obligation.

Nine months into the contract, the contractor and the customer agree to add five more sites to the contract and increase the total compensation. Also, due to matters identified early in the design phase, the contractor was forced to change the original design during the design phase, which increased costs by CU 1,000,000 – bringing the total estimated costs of the contract to CU 4,400,000. To compensate the contractor for these additional costs associated with the change to the original design and for the additional five sites, the customer agreed to increase the total consideration to CU 6,800,000. The contractor concludes that the additional CU 2,000,000 of compensation exceeds the standalone selling price for implementation at the additional five sites.

In this scenario, the contractor would likely conclude that all of the promised goods and services (including the additional five sites) are part of a single performance obligation, consistent with its original conclusion. Therefore, the ED would require the contractor to update the transaction price and the measure of progress toward satisfaction of the performance obligation as of the date of the modification, rather than treat the modification as a separate contract.

Assume that up to the date of the modification the contractor had incurred costs of CU 1,000,000. Therefore, the contractor had previously determined it was 29% complete in satisfying its overall performance obligation (CU 1,000,000/CU 3,400,000 – with the latter being the original estimated contract costs) and had recorded CU 1,400,000 in revenue (29% X CU 4,800,000 – being the original consideration for the contract).

Based on the revised costs under the modified agreement, the contractor determines it is 23% complete (CU 1,000,000/ CU 4,400,000 – with the latter being the new estimated contract costs). Accordingly, the contractor determines cumulative revenue to date should be CU 1,600,000 (23% x CU 6,800,000), compared with the CU 1,400,000 recorded to date, and therefore needs to recognise an adjustment to increase revenue by CU 200,000 – which would be recognised in the period that the modification was finalised.

How we see it

In the oilfield service sector many contracts would have a single performance obligation. Consequently, contract modifications that relate to a single performance obligation that is partially satisfied as of the date of the modification would be the most common accounting treatment.

We do not believe that the accounting treatment under the ED would differ significantly from current practice. However, if an entity had identified more than one performance obligation in the contract and determined that, at the time of the modification, some or all of the completed performance obligations were distinct from those still to be provided, the proposal would require accounting that would likely differ from current practice.

Step 2: Identify the separate performance obligations

The ED defines a performance obligation as a promise in a contract with a customer to transfer a good or service to the customer. The goods or services promised in a customer contract, which may either be explicitly stated in the contract or may be implied by customary business practices, are the potential performance obligations.

Distinct goods or services

After identifying the promised goods or services, an entity would determine which of them would be accounted for as separate performance obligations. That is, the entity would identify which goods or services were "distinct" and thereby represent individual units of account. The proposal outlines a two-step process for making this determination which is summarised below.

Goods or services would be distinct when either:

- The entity regularly sells the good or service separately

Or

- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (from the entity or from another entity)

The ED would then require an entity to consider if the manner in which those goods or services have been bundled in an arrangement would require the entity to account for two or more goods or services as one performance obligation. This determination would be required regardless of whether or not those goods or services were determined to be distinct on their own, i.e., if the criteria below apply, the entity must bundle the distinct goods or services into a single performance obligation.

The ED specifies that, notwithstanding that the goods or services within a bundle may be distinct, they would be considered to not be distinct if both of the following criteria are met:

- The goods or services are highly interrelated and transferring the goods or services requires their integration into a combined item

And

- The bundle of goods or services is significantly modified or customised to fulfil the contract

The ED also provides a practical expedient allowing an entity to account for multiple distinct goods or services as one performance obligation when the underlying goods and services have the same pattern of transfer. Based upon the commentary in the Basis for Conclusions, we believe the same pattern of transfer could occur either when there is simultaneous transfer (i.e., at the same point in time) of two or more performance obligations or consecutive transfer (e.g., the satisfaction of two performance obligations for which progress is measured using labour hours). Consequently, separate performance obligations could be combined as one performance obligation under this provision.

We generally believe these provisions address many of the concerns raised by construction and manufacturing respondents about the original ED issued in 2010 in that, for many construction contracts, it is likely to often result in the identification of a single performance obligation that will be satisfied over time. However, the required assessment of distinct performance obligations may be complex and would require the use of judgement, taking into consideration all of the facts and circumstances, with the key considerations being the level of customisation of products and services required by the contract and the degree of integration into one item.

The following example illustrates how an entity might consider each of the criteria described above.

Illustration 4 — Multiple goods and services

An oilfield services company enters into a contract with a customer to design, build and maintain five pumps to be used in the customer's oil and gas operations in the region.

Scenario A

The company is creating a new design on which to base the five pumps. Therefore, it anticipates significant design modifications as the build phase begins. The design and build of the pumps involves multiple goods and services from various technical resources and complex procurement, assembly and installation of all of the materials. Several of the goods and services could be considered separate performance obligations because the company regularly sells services such as engineering and build services, based on third-party designs, on a standalone basis.

However, because of the relationship between the design and build phases (i.e., the two phases are highly interrelated), the company determines that these goods and services represent a single distinct performance obligation. This is supported by the significant customisation and modification of the design and build services required to fulfil the obligation under the contract. However, the company concludes that the maintenance phase of the arrangement is not highly interrelated with the design and build services, and that it constitutes a separate performance obligation.

Scenario B

The five pumps are based largely on an existing design with only limited changes expected. The company does not believe there will be significant re-design in the build phase given its history with this type of pump. Although the build phase depends on the design phase, the design phase does not depend on the build phase. Further, the design services and build services are fulfilled with separate resources.

The company concludes that the design and build phases are not highly interrelated. As the ED would require goods or services to be both highly interrelated and significantly customised or modified to be treated as a single performance obligation, the design and build phases would each be accounted for as separate performance obligations.

Furthermore, the company would likely determine that each pump represents a distinct performance obligation.

The company concludes that the subsequent maintenance of the pumps would not be bundled with the design or construction phases of the contract as they are not highly interrelated with these phases. Therefore, all three phases would be treated as separate performance obligations.

Goods or services that are not distinct

If a good or service is not distinct from the other goods or services in the contract, an entity is required to combine that good or service with other promised goods or services until a bundle is distinct for the purposes of applying the proposed requirements. The combination of multiple non-distinct goods or services could, in certain circumstances, result in the entity accounting for all of the goods or services promised in the contract as a single performance obligation.

How we see it

The general requirement to determine whether the promised goods or services in an arrangement are distinct from other goods or services is a critical component of the proposed standard.

In the oilfield services sector, it is common for arrangements to require a contractor to manufacture many components and perform a variety of tasks to deliver an overall solution. In such cases, the goods or services may represent a bundled offering, i.e., a single performance obligation. Understanding the relationship of the deliverables within the arrangement would be critical. Significant judgement would be required. There may be contracts that do not create a single performance obligation, in which case a greater level of detail is required.

Customer options to purchase additional goods or services

Some contracts in the oilfield services sector may allow customers to exercise options to obtain additional goods or services. Under the ED, if an option provides a material right to the customer, it would be considered a separate performance obligation. A material right would be considered to exist when the customer has access to a significant incremental discount on the goods or services that would not otherwise be available to the customer. If an entity determines that an option does not provide a material right to the customer, the option would be considered a marketing offer and not a separate performance obligation.

An entity that determines that an option is a separate performance obligation would have to determine the separate standalone selling price (discussed further on page 15) of the option. If the standalone selling price is not directly observable, the entity would estimate it, taking into consideration the discount the customer would receive and the likelihood the customer will exercise the option. A portion of the transaction price would then be allocated to the option on a relative standalone selling price basis.

Currently, IFRS does not provide application guidance on how to distinguish between an option and a marketing offer. Nor does it address how to account for options that provide a material right. As a result, some entities may have effectively accounted for such options as marketing offers. The ED would establish requirements for accounting for such options.

Distinguishing between options and marketing offers could impact the timing of revenue recognition for the portion of the transaction price allocated to an option. A careful assessment of contractual terms to determine whether the entity has granted its customer a material right could require the exercise of significant judgement in some situations. The proposed requirements on how much of the transaction price should be allocated to an option is significantly different from current practice due to the lack of guidance in IFRS. See Section 5.1.1 of our general publication for further discussion on this issue.

Step 3: Determine the transaction price

The ED defines the transaction price as "the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, sales taxes)."[2] In many cases, the transaction price is readily determined because the entity receives payment at the time it transfers the promised goods or services and the price for the goods or services delivered is fixed.

Determining the transaction price may be more challenging when it is a variable amount, when payment is received at a time different from when the entity provides goods or services or when payment is in a form other than cash. Consideration paid or payable by the entity to the customer may also affect the determination of transaction price.

It is important to note that the ED contains certain significant changes from the 2010 ED. First, the ED would no longer require collectability to be considered when determining the transaction price. In addition, while the time value of money would have to be considered in an arrangement, the Boards tried to reduce the number of contracts to which that provision would apply (refer to page 12 for further discussion on the impact of the time value of money).

Variable consideration

The ED provides examples of factors that can cause the transaction price of a contract to vary in amount and timing. These factors include discounts, rebates, refunds, credits, incentives, bonuses, penalties, contingencies or concessions. For example, a portion of the transaction price would be variable at contract inception if it requires meeting specified performance conditions and there is uncertainty regarding the outcome of such conditions, e.g., early completion bonuses.

[2] ED Appendix A.

When there is variable or contingent consideration, the ED requires an entity to estimate the amount of variable consideration using either the "expected value" (probability weighted) or the "most likely amount" approach, whichever better predicts the ultimate consideration to which the entity will be entitled. Each of these methods is discussed further in Section 4.1 of our general publication.

The requirements in the ED state that in applying either approach, an entity would consider all of the information (historical, current and forecast) that is reasonably available. While the Boards did not explicitly state this in the ED, they appear to presume that an entity will always be able to estimate anticipated amounts of variable consideration.

How we see it

For a number of entities, the treatment of variable consideration and the proposed requirements relating to when variable consideration can be recognised, could represent a significant change from current practice.

Currently, IFRS preparers often defer measurement of variable consideration until revenue is reliably measurable, which could be when the uncertainty is removed or when payment is received. The ED would require entities to estimate variable consideration at contract inception. In addition, the ED would allow variable consideration to be allocated to specific distinct goods or services within certain bundles if certain criteria were met (refer below at "Step 4 – Allocate the transaction price" for further information).

Time value of money

For certain transactions, the timing of payment by the customer may not match the timing of the transfer of goods or services to the customer (e.g., the consideration is either paid by the customer in advance or is paid well after the goods or services are provided). When the customer pays in arrears, the entity is effectively providing financing to the customer. Conversely, when the customer pays in advance, the entity has effectively received financing from the customer.

As noted above, the Boards have tried to reduce the number of contracts to which the proposed time value of money requirements would apply, by stating that the time value of money would only have to be considered in determining the transaction price of the contract if the contract has a financing component that is significant to the contract. The ED then provides various factors for an entity to consider when determining whether a financing component is significant to a contract. These include but are not limited to:

- The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services
- Whether the amount of consideration would differ substantially if the customer paid in cash promptly in accordance with typical credit terms in the industry or jurisdiction

And

- The interest rate in the contract and the prevailing interest rates in the relevant market

In addition to limiting this provision to contracts with significant financing components, the Boards also provided a practical expedient in that an entity would not be required to assess whether the arrangement contains a significant financing component if the entity expects at contract inception that the period between payment by the customer of all or substantially all of the promised consideration and the transfer of the promised good or services to the customer will be one year or less. We explore the impact of this exception on advance payments and retentions below.

Advance payments or retentions

The inclusion of the various factors listed above highlights the Boards' agreement that the length of time between performance and payment should not necessarily be the only factor that determines whether a contract includes a significant financing component. One of the factors included refers to the typical credit terms in an industry or jurisdiction. This was included because it was understood that in some situations, a payment in advance or in arrears in accordance with the typical payments terms of an industry or jurisdiction may have a primary purpose other than financing.

One of the specific examples provided in the ED relates to retentions, i.e., where a customer retains or withholds an amount of consideration that is payable only on successful completion of the contract or on achievement of a specified milestone. The ED notes that the purpose of these payment terms may not be to provide financing, but primarily to provide the customer with assurance that the entity will satisfactorily complete its obligations under the contract. In such a situation, the effect of the time value of money may not be significant.

In addition, some respondents to the 2010 ED suggested that the Boards exempt an entity from having to reflect in the measurement of the transaction price the time value of money associated with advance payments. This was because: a) requiring such an adjustment would represent a change from current practice (as the time value of money implicit in an advance payment is typically not recognised); b) the accretion of interest on these advance payments would result in the recognition of revenue of an amount greater than the amount actually paid in advance; and c) reflecting the time value of money would not reflect the economics of the arrangement when the customer pays in advance for reasons other than financing, e.g., the customer is a credit risk or is compensating the entity for incurring upfront contract costs.

While the Boards could be persuaded to exempt entities from accounting for the effects of the time value of money on contracts to which the practical expedient applied (outlined above), they could not be persuaded to exempt entities from accounting for the time value of money effects of advance payments. This was because they believed that ignoring the time value impact on advance payments could substantially skew the amount and pattern of profit recognition if the advance payment is large and occurred well in advance of the transfer of goods or services to the customer.

What is not clear is exactly how the significant financing component requirements should be applied in practice. Refer to Section 4.2 of our general publication where these issues are considered.

Illustration 5 – Treatment of advance payments

A contractor enters into an arrangement with a customer to provide design and construction services that will take the entity three (3) years to complete. The entity determines that, due to the interrelationship between the design and construction services and the level of customisation required to provide these goods and services, these represent a single performance obligation, and this performance obligation is satisfied over the three years. The total contract price is CU 100,000,000.

The customer makes an advance payment to the contractor of CU 20,000,000, representing 20% of the total transaction price. At the date of receiving this payment the contractor would recognise the following journal entries:

DR Cash	CU 20,000,000	
CR Advance payment		CU 20,000,000

The terms of this advance payment are such that when the contractor raises invoices progressively over the contract period as the goods and services are provided (and as the performance obligation is progressively satisfied), 20% of the invoice amount is considered to be settled from the advance payment. The customer is required to pay the remaining 80% of the invoice at or near the time the goods and services are transferred to the customer. So if the contractor raised an invoice for CU 1,000,000, it would recognise the following journal entries:

DR Receivable	CU 800,000	
DR Advance payment	CU 200,000 (CU 1,000,000 x 20%)	
CR Revenue		CU 1,000,000

Illustration 5 – Treatment of advance payments (Continued)

While it is clear that an advance payment has been received in relation to a contract that has a duration greater than one year, this payment is progressively allocated (at a rate of 20% per invoice) as the goods and services are provided to the customer over the three year period.

This means that some of the performance obligation will be satisfied within the first 12 months, and therefore the time between some of the advance payment by the customer and the transfer of the promised goods and services will be one year or less. However, for the remaining portion of the advance payment that relates to the performance obligation to be satisfied throughout years two and three, the timing between payment and transfer will be greater than one year, which may suggest the time value of money has to be accounted for.

How we see it

While we understand that the practical expedient was added to try to simplify the application of the proposed standard, in some instances it is not clear how the requirements are to be applied, particularly in contracts with advance payments such as those described above, which are common in some oilfield services contracts. Given this, we believe the Boards should either clarify how this should be applied or provide additional application guidance to ensure these requirements have the desired effect and are correctly applied.

Step 4: Allocate the transaction price

Once the performance obligations are identified and the transaction price has been determined, the ED would require an entity to allocate the transaction price to the performance obligations, generally in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). As a result, any discount or variability within the contract would generally be allocated proportionally to all of the separate performance obligations in the contract. However, there are two exceptions to this basic principle.

Exceptions to the allocation principle

The first exception relates to the allocation of a discount. The ED contemplates the allocation of a discount in an arrangement to only one, or some, of the performance obligations if certain criteria are met. Specifically, the ED would allow an entity to allocate a discount inherent in a bundle of goods or services to an individual performance obligation (or smaller bundle of goods or services) when the pricing of that good or service is largely independent of others in the contract. That is, an entity would be able to effectively "carve off" an individual performance obligation and allocate a discount to that performance obligation if the entity determines the discount is specific to that good or service. Section 5.4 of our general publication discusses the requirements of allocating a discount in more detail.

The second exception relates to variable or contingent consideration. The ED states that variable or contingent consideration can be allocated entirely to a distinct good or service if both of the following criteria are met:

- The variable or contingent payment terms for the distinct good or service relate specifically to the entity's efforts to transfer that good or service

And

- The amount allocated depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring that distinct good or service

For example, assume an entity had a contract that it determined comprised two performance obligations, e.g., a construction phase and an operate phase, and the entity would be entitled to a bonus should the construction phase be completed early. If the entity could satisfy the criteria above, it could allocate that variable transaction price entirely to the construction performance obligation.

Estimating the relative standalone selling price

To allocate the transaction price on a relative standalone selling price basis, an entity must first have a standalone selling price for each performance obligation. Under the ED, the standalone selling price would be the price at which an entity would sell a good or service on a standalone basis at contract inception. The ED indicates the observable price, when available, of a good or service sold separately provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. The ED also makes it clear that the entity should not presume that a contractually stated price or a list price for a good or service is the standalone selling price. For example, a vendor enters into a contract with Customer A to provide good A at CU 100, good B at CU 75 and good C at no cost. To allocate the transaction price appropriately, the vendor would have to determine the standalone selling prices for each of the goods and not simply use the rates stated in the contract. Section 5.1 of our general publication provides a more detailed discussion of the requirements for determining the standalone selling price.

One thing that is not clear in these requirements, particularly in relation to longer term contracts, is how to determine the relative standalone selling price for each performance obligation at contract inception when some performance obligations are to be satisfied several years after contract inception. For example, in the oilfield services sector an entity may enter into a 10-year contract with a customer with three performance obligations comprising: 1) the design and construction of some oil and gas production facilities; 2) the operation of those facilities for the life of the field (which is assumed to be the 10 years); and 3) decommissioning those facilities. At contract inception, to allocate the transaction price the entity would need to determine the relative standalone selling price of each of these performance obligations.

To do this, does the entity determine the price at which it would sell the decommissioning services if those services were provided today, or does it estimate the price it would charge to provide those services in the future? This is an important distinction because if those prices were significantly different, this would alter the allocation of the transaction price at contract inception and ultimately the revenue recognition profile. However, we believe that today's price would be the starting point for such an estimation.

How we see it

Given the impact the assumptions around the standalone selling price can have upon the allocation of the transaction price and the recognition of revenue, we believe the Boards should clarify how such prices should be determined, particularly when the performance obligations are to be satisfied over a long period.

Step 5: Satisfaction of performance obligations – recognising revenue

Under the ED, an entity would recognise revenue only when it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is generally considered to be transferred when the customer obtains control. The ED states that "control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset."[3] Control also includes the ability to prevent other entities from directing the use of and receiving the benefit from a good or service.

The ED indicates that certain performance obligations are satisfied at a point in time and revenue would be recognised at that point in time. Other performance obligations are satisfied over time, and the associated revenue would be recognised over the period the performance obligation is satisfied.

Performance obligations satisfied over time

Frequently, entities transfer promised goods or services to the customer over time. While the determination of whether goods or services are transferred over time is straightforward in some arrangements (e.g., many service contracts), the Boards acknowledged that it may be more difficult in many other arrangements.

[3] ED Paragraph 32.

To help entities determine when control transfers over time (rather than at a point in time), the Boards specified that an entity transfers a good or service over time if at least one of the following two criteria are met:

- The entity's performance creates or enhances an asset (such as work in progress) that the customer controls as the asset is created or enhanced (for example, if the customer takes title as the goods are produced)

Or

- The entity's performance does not create an asset with an alternative use to the entity (for example, if the contract includes provisions that prevent the transfer of the goods or services to another party) and at least one of the following criteria is met:
  - The customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs (e.g., training provided to employees of the customer).
  - Another entity would not need to substantially re-perform the work the entity has completed to date if that other entity were to fulfil the remaining obligation to the customer.
  - The entity has a right to payment for performance completed to date, and it expects to fulfil the contract as promised. The right to payment for performance completed to date does not need to be for a fixed amount. However, the entity must be entitled to an amount that is intended to at least compensate the entity for performance completed to date even if the customer can terminate the contract for reasons other than the entity's failure to perform as promised. Compensation for performance completed to date includes payment that approximates the selling price of the goods or services transferred to date (e.g., recovery of the entity's costs plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract is terminated. For instance, if a contract included provisions that permitted the customer to terminate the contract and take possession of any work in progress with payment to the entity for performance completed to date.

We believe that many of the arrangements in the oilfield services sector would be considered contracts in which performance obligations are satisfied over time.

How we see it

All performance obligations would need to be carefully evaluated to determine whether they are satisfied over time. We believe many of the performance obligations within arrangements currently accounted for under IAS 11 would meet the proposed criteria to recognise revenue over time rather than at a point in time.

Measurement of progress

Revenue for a performance obligation satisfied over time would be recognised "by measuring the progress toward complete satisfaction of that performance obligation." The objective is to reflect the entity's performance under the contract, similar to existing IFRS. The ED specifically identifies both output and input measures as acceptable measures of progress. Furthermore, similar to existing IFRS, the ED would require an entity to have the ability to make reasonable estimates and to apply completeness measurements in the same manner across similar contracts to recognise revenue prior to completion.

The ED provides examples of output measures, which include surveys of performance completed to date, appraisals of results achieved, milestones reached or units produced. Moreover, the ED specifically indicates that when an entity has a right to invoice a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (e.g., service contracts under time-and-materials arrangements), the entity would recognise revenue in the amount invoiced and this is considered a type of output method.

The ED also considers input measures, which recognise revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation – for example, resources consumed, labour hours expended, costs incurred, time lapsed or machine hours used, relative to the total expected inputs required to satisfy the performance obligation. One key condition is that the use of input measures should not include any measurement that does not depict the transfer of goods or services to the customer. This concept may apply to some contracts in the oilfield services sector when there are up-front purchases of materials on a long-term construction contract.

While such costs are directly related to the contract, they would not be included in the measurement toward completion until the materials have been integrated into the final product if the entity was using a cost-to-cost input method. When significant procurement services are being provided as part of the contract, and these are considered to be a separate performance obligation, revenue may be recognised on those services using a different measurement approach. However, if the procurement and construction services were treated as a single performance obligation the entity would need to select a single measure of progress and apply it to the single performance obligation.

The ED indicates no preference for output measures over input measures, but does clarify that the selected method would be consistently applied to similar arrangements containing similar performance obligations.

How we see it

When an entity has contracts with performance obligations that are satisfied over time, the ED requires the entity to apply a method of measuring progress that depicts the transfer of goods or services to the customer. Determining an appropriate measure may differ when significant design or procurement services have been bundled with the production and delivery of tangible goods. For example, using the "units of delivery" method would not accurately capture the level of performance and would exclude an entity's efforts during the design and procurement phases, compared to situations in which the design services are a separate performance obligation from the construction services.

Constraining the cumulative amount of revenue recognised

Although an entity would estimate the total transaction price (without any constraint on the estimate), the amount of revenue the entity could recognise upon satisfaction (or partial satisfaction) of a performance obligation, may be constrained. The ED states that the cumulative amount of revenue an entity would be able to recognise for a satisfied or partially satisfied performance obligation is limited to the amount to which the entity is "reasonably assured" to be entitled. Refer to Section 6.3 of our general publication for further guidance on determining when the amount to which an entity expects to be entitled is reasonably assured.

Bill-and-hold arrangements

There may be sales transactions in which the entity fulfils its obligations and bills the customer for the work performed, but it does not ship the goods until a later date. This scenario would typically arise at the request of the customer due to a lack of storage capacity or delays in the customer's ability to use the goods.

Under the ED, the entity would evaluate whether the customer has obtained control of the goods to determine whether the performance obligation(s) had been fully satisfied and revenue should be recognised. As the customer has not yet taken possession of the goods, the ED includes certain criteria for bill-and-hold arrangements that are largely consistent with current IFRS. We expect that, where relevant, most bill-and-hold arrangements that would qualify for revenue recognition under current IFRS would also qualify for revenue recognition under the ED.

Other measurement and recognition topics

Onerous performance obligations

The ED would require an entity to recognise a liability and a corresponding expense (not a reduction in revenue) when performance obligations (i.e., performance obligations satisfied over time where that period of time is greater than one year) become onerous.

It is important to note that the proposal would require the measurement of a loss for an onerous performance obligation at the performance obligation level rather than at the contract level, as currently required under IFRS. While some entities would bundle the performance obligations in an arrangement into a single unit of account, the proposal would represent a change from current practice for entities that identify multiple performance obligations in an arrangement. Refer to Section 7.2 in our general publication for further discussion.

How we see it

The onerous assessment would be required to be completed at the performance obligation level. The onerous performance obligation calculation would be based on the direct costs of satisfying the performance obligation and would not take into consideration situations in which the overall profitability of the entity is enhanced as a result of the contract as a whole, e.g., because the contract covers the variable costs of the contract and a portion of the entity's fixed costs.

In such situations, the requirement to recognise potential losses in advance at the performance obligation level may provide reporting results that do not reflect the underlying economics of the arrangement and its effect on the entity's profitability.

Contract costs

The proposed standard includes requirements for costs incurred in obtaining and fulfilling a contract to provide goods or services to customers for both contracts obtained and contracts under negotiation. This differs from existing requirements in IFRS, which generally apply only when an entity has obtained a contract.

Costs to obtain a contract

Under the ED, the incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained, such as a bonus paid to those involved in the contracting process) would be recognised as an asset, but only when the costs are expected to be recovered. Recovery of incremental costs can consider both direct recovery (i.e., through reimbursement under the contract) or indirect recovery (i.e., through the margin inherent in the contract). As a practical expedient, the ED permits immediate expense recognition for contract acquisition costs related to contracts with a duration of one year or less. While this is not explicitly stated, we believe entities would be permitted to choose this approach as an accounting policy election and, if they did so, would have to apply it consistently to all short-term contract acquisition costs.

How we see it

The proposal in the ED could represent a significant change for entities that currently expense the costs of obtaining a contract with a duration of greater than one year as they would be required to capitalise them.

The ED also implies that the unit of account for costs of obtaining a contract would be the contract (potentially including contract renewals), which could force some entities to analyse contract acquisition costs in more detail than they currently do.

Costs to fulfil a contract

The ED divides costs to fulfil a contract into two categories – those that give rise to an asset and those that should be expensed as incurred. When considering the appropriate accounting treatment for contract fulfilment costs that do not qualify for capitalisation, the ED makes it clear that any other applicable standards should be considered first (such as IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*).

The ED states that contract fulfilment costs that are not eligible for capitalisation under other authoritative literature would be recognised as assets if the costs meet all of the following criteria:

- The costs relate directly to a contract or a specific anticipated contract. Costs may include direct labour, direct materials, allocations of costs that relate directly to the activities involved in fulfilling the contract, costs that are explicitly chargeable to the customer under the contract and other costs that were incurred only because the entity entered into the contract (e.g., sub-contractor arrangements).
- The costs generate or enhance resources of the entity to be used in satisfying performance obligations in the future. These costs may include intangible design or engineering costs that relate to future performance and will continue to provide benefit.
- The costs are expected to be recovered.

All other costs would be expensed as incurred, including costs relating to previously satisfied performance obligations for which there is no future benefit, costs of wasted materials, excess labour or other materials used to fulfil the contract that were not reflected in the price of the contract and that do not further the satisfaction of the unfulfilled performance obligation.

Under IAS 11, contractors generally capitalise certain indirect costs within inventory. Under the ED, we believe the indirect costs would continue to be capitalised if they are explicitly chargeable to the customer or represent the allocation of costs that directly relate to contract activities. Similarly, we would not expect the proposed requirements to affect the treatment of pre-contract costs provided they are incremental costs associated with obtaining the contract and they are recoverable, and/or they relate to costs that will generate or enhance resources of the entity to be used in satisfying performance obligations in the future.

Amortisation of capitalised costs

Any capitalised contract costs would ultimately be expensed (generally through amortisation) as the entity transfers the goods or services to the customer. It is important to note that certain capitalised costs will relate to multiple goods or services (e.g., design costs). For these costs, the amortisation period could extend beyond a single contract if the capitalised costs relate to goods or services being transferred under multiple contracts, or if the entity expects the customer to continue to purchase goods or services after the stated contract period.

Warranties

Warranties are commonly included in the sale of goods or services, whether explicitly stated or implied based on the entity's customary business practices. The price may be included in the overall purchase price or listed separately as an optional product. The ED identifies two classes of warranties:

- Warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract (referred to as "service-type warranties")
- Warranties that promise the customer that the delivered product is as specified in the contract (referred to as "assurance-type warranties")

Service-type warranties

If the customer has the option to purchase the warranty separately or if the warranty provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a service-type warranty. This type of warranty represents a separate service and would be an additional separate performance obligation. Therefore, the entity would allocate a portion of the transaction price to the warranty based on the estimated standalone selling price of the warranty. The entity would then recognise revenue related to the warranty over the period the warranty service is provided. Further details on warranties and the associated judgements are included in Section 7.1 of our general publication.

Assurance-type warranties

The ED concludes that assurance-type warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a quality guarantee. Under the ED, this type of warranty would be accounted for as a warranty obligation, and the estimated cost of satisfying the warranty obligation would be accrued in accordance with the requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Determining whether a warranty is an assurance-type or service-type warranty

Arrangements may include both an assurance-type warranty and a service-type warranty, which should be accounted for separately. However, if an entity provides both an assurance-type and service-type warranty within an arrangement and the warranties cannot be reasonably accounted for separately, they would be accounted for as a single performance obligation (i.e., revenue would be measured for the combined warranty and recognised over the period the warranty services are provided).

How we see it

The proposal for assurance-type warranties is essentially the same as current practice. The proposal for service-type warranties is similar to today's accounting, except for the amount of transaction consideration that would be allocated to the warranty performance obligation. Currently, entities that provide separate extended warranties typically defer an amount equal to the stated price of the warranty and record that amount as revenue over the warranty period. The ED would require an entity to defer an allocated amount, based on the relative standalone selling price.

Disclosures

The ED proposes significant changes to existing disclosure requirements. The Boards' overall objective is to create disclosures that would enable users of the financial statements to understand the "nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers."[4]

The proposed disclosures are both qualitative and quantitative in nature and would require entities to discuss estimates and judgements at greater length in the notes to their financial statements. Entities in the oilfield services sector may need to develop new processes and systems to track the detailed information that would be required by the proposed standard.

The ED does not provide application guidance or supplemental information on the depth of disclosure required to fulfil the overall disclosure objective. Therefore, entities likely would have to exercise significant judgement when preparing the proposed disclosures.

[4] ED Paragraph 8.

Disaggregation of revenue

The ED would require additional disclosure of disaggregated revenue on an interim and annual basis and provides categories that may be appropriate to meet the overall disclosure objective. The examples include the following:

- Type of goods or services
- Geography in which goods or services are sold
- Market or type of buyer, e.g., government vs. private sector
- Type of contract, e.g., fixed-price, time-and-materials and cost-plus
- Duration of the contract
- Timing of transfer of the goods or services
- Sales channels

How we see it

The implications of these proposed new disclosures may be far reaching and may represent a significant change for oilfield services entities. This is because:

- The frequency of disclosures would increase with these disclosures required to be provided both on an interim and annual basis
- The breadth of disclosures may be greater as we expect many oilfield services entities would use several of the categories proposed in the ED as the types of contracts, the duration of their contracts and types of goods or services may vary significantly. For example, a company might provide engineering, project management, operations and maintenance, environmental services and consultancy services across the one sector, or it may service multiple sectors

Satisfaction of performance obligations

For contracts with an original expected duration greater than one year, the ED would require an entity to provide additional disclosure of the transaction price allocated to remaining performance obligations and an explanation of when the entity expects the amount(s) to be recognised as revenue. The proposed disclosures can be provided quantitatively using "time bands" or using a combination of qualitative and quantitative information. Refer to Illustration 8–3 in our general publication for an example.

While not explicitly stated in the ED, we understand that these disclosure requirements also apply to the part of the transaction price allocated to partially unsatisfied performance obligations. For example, if an entity had a contract greater than one year but it determined that the goods or services provided under the contract represented a single performance obligation satisfied over time, at the end of Year 1 if the entity was 25% of its way through the satisfaction of its performance obligation, it would be required to disclose the portion of the transaction price that was allocated to the remaining 75% of the performance obligation still to be satisfied.

The ED also provides a practical expedient that would allow an entity to omit these disclosures for cost reimbursable and time-and-materials contracts. An example would be a services contract in which an entity has a right to invoice the customer a fixed amount for each hour of service provided as specified in the contract.

How we see it

The proposed disclosure requirements would represent a significant change for almost all oilfield services entities. The proposed requirement to disclose future revenues and the expected timing of satisfaction of performance obligations could require significant estimates to be made at a very granular level and then aggregated into judgemental "time bands".

We believe that these proposed disclosures are similar to the current disclosure requirements that may be included in Management's Discussion & Analysis or analyst presentations on backlog. However, the proposed disclosures would require discussion about the forecast realisation and timing of that backlog within the financial statements. Also, the inclusion of this information within the financial statements would mean they would need to be audited. Given the current diversity in practice on backlog calculations, we believe the proposed disclosure could present a significant challenge for contractors.

Day rate drilling contracts

Drilling contracts generally lay out specifications with respect to the drilling rig and equipment, timing and personnel. They can provide for charges based on: day rates for operating, standby and repair (e.g., offshore drilling contracts); the depth drilled (e.g., land drilling contracts); or sometimes, complete execution of a drilling programme. 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 the 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 section entitled "Scope" above).

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

Identifying performance obligations

Drilling entities would need to assess whether there are goods or services (e.g., catering, transportation, drilling materials and supplies, rental tools, etc.) in drilling contracts that represent separate performance obligations – that is whether the goods or services provided under the contract are distinct. If they are not distinct, the entity would then need to determine at what level these goods or services need to be bundled such that a distinct performance obligation can be identified. Further analysis may also be required to determine if distinct goods or services are required to be bundled or may be bundled by virtue of the practical expedient. Refer to our discussion on page 9, "Distinct goods or services" on how an entity determines if its goods or services are distinct and whether they could or should be bundled.

Identifying the performance obligations in the contract under the ED would be based on the individual facts and circumstances of the contract.

Determining and allocating the transaction price

The next steps are to determine, and then allocate, the transaction price. 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 would need to use one of the two options for determining variable consideration provided in the ED, the "expected value" or "most likely amount" approaches (as discussed in more detail on page 12, "Variable consideration").

Subsequent changes in the transaction price must be updated each reporting period and would need to be re-allocated to the separate performance obligations based upon their original standalone selling price. If an entity can demonstrate that the subsequent change related entirely to a distinct good or service, the change would be alllocated to that distinct good or service only. Refer to the discussion in Illustration 1 for more information. Such a requirement would result in changes to the revenue allocated to, and recognised for, already satisfied performance obligations as well as changes to future revenue yet to be recognised. Revisions to the estimated transaction price that are related to satisfied performance obligations would affect revenue in the period of the revision, which could result in volatility. The initial and subsequent determination of the transaction price could be quite difficult and time consuming.

Satisfaction of performance obligations – recognising revenue

Revenue for the drilling contract would be recognised when a performance obligation is satisfied. As discussed in "Step 5: Satisfaction of performance obligations – recognising revenue" above, performance obligations can be satisfied at a point in time or over time. For the former, satisfaction occurs when the customer obtains control of the related good or service, whereas for the latter, the entity would use an appropriate measure of progress (refer to page 15 for further information on performance obligations satisfied over time).

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, whether (and how) these can be bundled, 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.

Seismic services

There are two primary services provided by seismic entities. 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. The second service is providing a licence to information from data accumulated by the entity that is not customer-specific (i.e., a data library).

Data acquisition and processing

Seismic entities 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 the new proposals

Seismic entities would need to identify the performance obligations in the contract and determine whether they are distinct and require separation. If the entity regularly sells data acquisition services separate from processing services, then the performance obligations could initially be considered to be distinct. Alternatively, if the customer could benefit from data acquisition and processing services on its own or together with other resources that are readily available to the customer (from the entity or from another entity) those services would also initially be considered distinct. The entity would then consider whether any of the bundling provisions are required or available (see the criteria listed on page 9 "Distinct goods or services" for discussion on distinct goods and services and the bundling requirements/options).

Seismic entities would need to determine the transaction price for the contract and allocate it to each performance obligation based on its relative standalone selling price. As seismic entities often perform these services separately, estimating the standalone selling price may not be a significant challenge.

Revenue would be recognised when the performance obligations are satisfied. This 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. This means that, if the customer cancels the contract with the seismic entity, it is entitled to the data that has been captured and/or processed to date and hence such goods or services would be considered to be transferred to the customer on a continuous basis, i.e., performance obligations satisfied over time.

The ED indicates that output and input methods are suitable for recognising revenue on arrangements involving the continuous transfer of goods or services, but it does not indicate a preference for either type of method. It does, however, clarify that the selected method would be applied to similar arrangements containing similar performance obligations.

The ED does not include the passage of time specifically as a separate method of measuring progress. However, we believe the passage of time could be viewed as a subset of or proxy for an input or output measure if it appropriately depicts the pattern of transfer. For example, the Boards specifically included "time lapsed" as an example of a type of input measure an entity may use. As a result, there may not be a significant difference between current IFRS and the 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 (if they cannot be bundled into one single performance obligation) and the customer's rights to the output. Further information on measuring progress towards the satisfaction of a performance obligation can be found on page 16, "Measurement of progress", above.

Illustration 6 – Seismic data acquisition and processing

Seismic Company A is contracted to perform data acquisition and processing services on Area A for Oil and Gas Company for a fixed fee of CU 120,000. Seismic Company A identifies the acquisition and processing services as separate performance obligations and they would not bundle them.

Seismic Company A estimates the standalone selling price of data acquisition costs to be CU 130,000 and the standalone selling price of processing services to be CU 10,000. The transaction price is allocated to each performance obligation as follows:

	Stand alone selling price	% of total	Allocated transaction price
Data acquisition	CU 130,000	93%	CU 110,400
Processing	CU 10,000	7%	CU 9,600
	CU 140,000		**CU 120,000**

How we see it

Entities would need to undertake further analysis to identify the separate performance obligations, determine whether the performance obligations are satisfied over time, determine the transaction price and then allocate this to the various performance obligations based upon the relative standalone selling prices. Consequently, it is possible that the timing of revenue recognition may change.

Data licensing

Seismic entities 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 licensing 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 the new proposals

Paragraph B34 of the ED explains that if an entity grants to a customer a licence or other rights to use intellectual property of the entity, those promised rights give rise to a performance obligation that the entity satisfies at the point in time when the customer obtains control of the rights. Control of rights to use intellectual property cannot be transferred before the beginning of the period during which the customer can use and benefit from the licensed intellectual property.

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 ED would be recognised when the customer has obtained the right to the information.

How we see it

Generally, the accounting for data licences would be consistent with current revenue recognition practices.

Next steps

As the nature and complexity of the goods or services that oilfield services entities provide, and the types and complexity of contracts they enter into can vary significantly, entities should familiarise themselves not only with the matters outlined in this supplement, but also with the details of the new revenue recognition model in general. This will assist them in:

- Fully analysing the potential impact of this proposed standard on their common transactions
- Identifying any situations where the accounting may not reflect the substance of a transaction or may differ from the current accounting

  And
- Identifying potential application issues

This will also assist them in providing input to the IASB as they proceed to finalising the standard and in keeping their Audit Committee, Board and auditors apprised of the potential implications. Furthermore, entities should consider the process for communications with shareholders, analysts and other users.

Ernst & Young's Global Oil & Gas Center

The oil and gas sector is constantly changing. Increasingly uncertain energy policies, geopolitical complexities, cost management and climate change all present significant challenges.

Ernst & Young's Global Oil & Gas Center supports a global practice of over 9,000 oil and gas professionals with technical experience in providing assurance, tax, transaction and advisory services across the upstream, midstream, downstream and oilfield service sub-sectors. The Center works to anticipate market trends, execute the mobility of our global resources and articulate points of view on relevant key sector issues. With our deep sector focus, we can help your organization drive down costs and compete more effectively to achieve its potential.

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