In the Spotlight

An Oil and Gas Industry Focus on COVID-19 Accounting Considerations

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COVID-19: Top Accounting Issues in the Oil and Gas Industry

At a glance:
The COVID-19 outbreak has developed rapidly in 2020, with a significant global impact. Measures taken to contain the virus have affected economic activity, which in turn has implications for financial reporting.

Measures to prevent transmission of the virus include limiting the movement of people, restricting flights and other travel, temporarily closing businesses and schools, and cancelling events. This will have an immediate impact on businesses such as tourism, transport, retail and entertainment. It will also begin to affect supply chains and the production of goods throughout the world, and lower economic activity is likely to result in reduced demand for many goods and services.

COVID-19 will impact many areas of accounting and reporting for all industries, as outlined in our publication: https://inform.pwc.com/s/Accounting.implications.of.the.effects.of.coronavirus.PwC.In.depth.2020_02/informContent/2033163303178016#ic_2033163303178016.

Oil and gas entities have been particularly impacted by the outbreak, because of decreased demand for crude oil which has not been matched by decreased production. At the time of publication, oil prices are nearing historic lows in some indices. In addition, some operations have been curtailed / suspended as a result of the virus.

In this Spotlight we provide our insights into the top nine issues that oil- and gas-related entities might face. While this Spotlight focuses on issues that are likely to be the most frequently encountered, many others are certain to arise. As the situation continues to evolve, so too will the consequential accounting issues. For these reasons, the following is not an exhaustive list of all relevant accounting considerations.

The top issues that we expect to see impacting oil and gas entities are:
1. Impairment triggers for goodwill and PP&E, and associates and joint ventures
As a result of the depressed prices of oil and gas, it is probable that there will be impairment triggers for many entities in relation to goodwill and property, plant and equipment (‘PP&E’) as well as associates and joint ventures. Oil reserves might also be impacted by decreases in economic recoverability.

The In depth provides helpful tips that would apply to such tests.

2. Commodity contract considerations
Oil and gas entities often enter into commodity contracts under long-term, non-cancellable agreements. To the extent that the entity is selling or purchasing volumes that are no longer required, these contracts might become onerous or they might no longer be held for the entity’s ‘own use’.

Where purchase or sales contracts are net settleable in accordance with IFRS 9 (for example, because the underlying is readily convertible to cash or because the contract permits cash settlement) and the entity is no longer holding such contracts for ‘own use’, they might need to be accounted for as derivatives measured at fair value through profit or loss in accordance with IFRS 9.

In addition, entities should be on the lookout for contracts that have become onerous. Such contracts might include, for example, non-cancellable supply / service contracts for which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received.

3. Impairment considerations for exploration and evaluation (‘E&E’) assets
E&E assets are assessed for impairment using criteria in paragraph 20 of IFRS 6, including where:

- substantive expenditure on further exploration for and evaluation of mineral resources in the specific area is neither budgeted nor planned
- sufficient data exist to indicate that, although a development in the specific area is likely to proceed, the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full from successful development or by sale.

In particular, entities should consider whether current economic conditions mean that there is not a reasonable expectation that such E&E assets will be developed. An entity might not be able to continue with exploration for a variety of reasons, including factors such as an inability to obtain necessary financing to continue exploration or because forecast pricing would not support recoverability of exploration costs even if hydrocarbons are discovered.

Where indicators of impairment exist for E&E assets, they should be tested for impairment in accordance with IFRS 6 and IAS 36.

4. Liquidity considerations
The decrease in pricing or disruption to operations could lead to potentially significant declines in cash flows and therefore impact:

- the going concern assumption;
- liquidity risk disclosures; and
- debt covenants, in particular for reserves-based lending arrangements.

The impacts on these items will need to be carefully monitored. Further details on these implications are discussed in In Depth 2020-021: Accounting implications of the effects of the Coronavirus.
5. Expected credit losses
IFRS 9 requires entities to use an expected credit loss (‘ECL’) model to measure impairment of most financial assets. The model requires consideration of both historical and current information, as well as reasonable and supportable forecasts of future conditions (including macroeconomic information).

Many oil and gas entities use the simplified model for trade receivables and measure the ECL for the lifetime expected credit losses. Macroeconomic factors could impact the measurement and result in higher expected credit losses due to the credit deterioration of customers.

In addition, ECL associated with guarantees (for example, where an entity has provided guarantees in favour of joint venture partner borrowings) might also increase.

6. Inventories
Current pricing levels might mean that inventories need to be written down. If production significantly outstrips demand, entities might experience operational issues, storage prices might increase, and entities in certain locations might be forced to sell below benchmark prices. In some cases, realisable prices might fall below the marginal cost of production, or inventories of purchased products (such as for blending) might have costs that exceed recoverable amounts.

Entities carrying inventory at fair value (for example, commodity broker / dealers) also need to consider the potentially significant impact on the fair value measurement of such inventories.

7. Force majeure clauses
Entities in the oil and gas sector often have contracts which contain force majeure clauses, which can relieve parties of all or certain obligations in a contract in the case of serious unforeseen circumstances beyond the control of the parties to the contract.

Entities should seek to understand the scope of such clauses in their contracts, and how such clauses might apply in the relevant legal jurisdiction. Such clauses could, for example, impact both contracts for the purchase of goods or services and revenue or lease arrangements. In some cases, significant judgement might be required to interpret such clauses.

Where such clauses are triggered, the impact on revenue, purchase or other arrangements will need to be considered, and entities will need to consider what disclosures are required in such circumstances.

8. Decommissioning obligations
Changes to development plans, including changes to the reserve life of individual wells, might trigger changes to the expected timing or costs of decommissioning obligations and impact the measurement of such obligations. In addition, interest rates have been impacted by the current economic situation and this will likely result in changes to the discount rate applied to these obligations.

9. Recoverability of deferred tax assets
Changes to forecasts of taxable income might impact the ability to recover deferred tax assets (for example, the ability to use loss carry-forwards prior to expiry). As such, some deferred tax assets might no longer qualify for recognition.

Conclusion
COVID-19 has given rise to unprecedented challenges that have affected virtually every aspect of modern life. The economic implications of the virus will have a consequent impact on many aspects of accounting and financial reporting. Entities in the oil and gas industry face some of the biggest accounting challenges, and we hope that this Spotlight will help you and your advisors as you navigate the key issues.