

UPSTREAM FINANCIAL REPORTING PRACTICES IN THE OIL AND GAS SECTOR

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Abstract

This paper has conceptually examined the upstream financial reporting Practices in the oil and gas sector. An in-depth exploration of existing literatures was made to buttress the views expressed by the researcher and prior researchers as regard the subject matter evaluated.

The study employs the desk top review methodology by examining existing literature on the topic in order to get adequate firsthand information. Findings emanating from the conceptual evaluation indicate that oil and gas serve as a major source of revenue; and as such there are no defined accounting standards that readily guide firms in their financial reporting in oil and gas sector of Nigeria. Premised on this, it is therefore suggested that the financial reporting council of Nigeria should specified specific standards for Nigerian firms in the oil and gas sector to improve their financial reporting practices subject to the IFRS requirements.

Keywords: upstream, financial reporting practices, accounting standards, oil and gas sector, oil and gas sector accounting method.

Introduction

The oil and Gas industry occupies a crucial aspect in a Nation's economy like Nigeria by way of sustaining the economy. It could be regarded as the nation's live wire and the very source of economic development and growth. The companies operating in the Oil and Gas Sector generate huge amount of money and pay about 85% of it as tax revenue to the government in Nigeria. The oil and Gas business is one that is most reliable for investment in both developed and developing countries, this is because they generate adequate returns to the shareholders and thereby maximize their wealth as well as meet the need of the varying stockholders.

The performance and financial positions of the Oil and Gas business as usual is revealed by the content of the annual financial reports and accounts. Prior to this period, the annual financial statements of companies in the Oil and Gas sector of Nigeria was prepared using the statement of accounting (SAS) prepared by the Nigeria Accounting Standard Board (NASB). These standards have now been phased out and replaced with the international financial reporting standards (IFRS). The use of IFRS in financial reporting practices by firms in Non-Oil sector and specifically in the oil sector reveals among other things the liquidity, profitability and gearing of the firms. Against this backdrop, this paper examines upstream financial reporting practices in the oil and gas sector.

Literature Review

Adoption of Financial Reporting Practices in the Oil and Gas Sector

The inadequacy of the Statement of Accounting Standards (SASs) and in addition with so many issues actually necessitated the Nigerian government to introduce series of economic reform programmes in the various sector on the economy in order to correct the aberration and to prosper the country among the twenty most developed Nations in the World by the year 2020 (Masud, 2013). He points out the most prominent reforms in the financial reporting practices in the Oil and Gas encompass the adoption of international financial reporting standards (IFRSs), the replacement of the Nigerian Accounting Standards Board (NASB), the body responsible for the insurance of SAS with the financial Reporting Council (FRC) and the establishment of the IFRS academy. There is no doubt that these different reforms are recent to improve the general financial reporting quality and practices of Nigerian companies, improve the comparability and transparency of their financial statement and reduce information asymmetry in the Oil and Gas sector especially, moreover, a petroleum industry Bill (PIB) with the purpose at revamping the Oil and Gas sector has been debated on by the National House of Assembly in Nigeria.

Financial reporting practices in the oil and gas sector

The Oil and Gas sector is otherwise referred to as the petroleum industry. The Oil and Gas sector basically involves the extraction and refining of petroleum products. The petroleum industry in the upstream activities category engages in the acquisition of mineral interest in properties, exploration, development and production of crude Oil and Gas. The Oil and Gas sector also engages in the process of acquisition of mineral rights, the exploration and drilling and the development which is the access obtained to provide reserves and provides facilities for extracting, gathering, treating and storing the Oil and Gas. In other

words, companies in the oil and gas industry may be involved in only upstream activities—exploration and production activities—or they may also be involved in downstream activities—transportation, refining, and marketing activities. Therefore, Oil and Gas sector have developed a wide diversity of accounting practices and reports. There are basically two accounting methods which include the full cost and successful effort method. This work focuses on the financial reporting practices in upstream activities of companies engaged in oil and gas operations.

The Upstream Oil Sector:

The upstream oil industry is the single most important sector in the economy. Since December 2005, Nigeria has experienced increased pipeline vandalism, kidnappings and militant takeovers of oil facilities in the Niger Delta. MEND is the main militant organization in the Niger delta attacking oil infrastructure for political objectives, claiming to seek a redistribution of oil wealth and greater local control of the sector. Additionally, kidnappings of oil workers for ransom are common and security concerns have led some oil services firms to pull out of the country and oil workers unions to threaten strikes over security issues. Despite the problems associated with persistent ethnic unrest, corruption, insecurity and political instability, Nigeria's wealth of oil makes it most attractive to the major oil-multinationals, most of whom are represented in Nigeria, with the major foreign stakeholder being Shell Nigeria petroleum exploration and production company (SNEPCO).

Accounting standards applicable in the oil and gas sector

The Nigerian Statement of Accounting Standards (SAS) or Nigerian GAAP, the UK GAAP and IFRS are in many ways different in terms of guidance and application of the standards, although, some of these standards are similar or comparable in certain areas. Most of the SAS under NG-GAAP are found to be similar to Financial Reporting Standards (FRS) and Statement of Standard Accounting Practice (SSAP) under UK-GAAP. This could be attributed to the strong interrelationships in terms of accounting education, oil and gas, business, finance, banking as well as the colonial relationship between the UK and Nigeria. The extractive industry is a specialized sector with lots of complications regarding the recognition, measurement, classification and treatment of assets in the books of Oil and Gas companies. Oil and Gas sector is characterized by heavy initial investment in terms of Exploration and Evaluation (E&E) operations. These activities require the use of high level and sophisticated technology for geological and geophysical (G&G) evaluation of the field to determine whether a commercially producible deposit of Oil and Gas is present. Despite the commitment of huge resources at the (E&E) stages, there is no guarantee that the well would produce a commercial quantity of Oil and Gas to pay for the investment. This unique nature of the extractive industry makes accounting for the Oil and Gas sector equally unique.

It is only in the extractive industry that different accounting methods (FC or SE) are used to account for the costs incurred in the acquisition, exploration, development and production phases of Oil and Gas production. A special standard "IFRS 6 – *exploration for and evaluation of mineral resources*" issued by the IASB is dedicated strictly for the extractive industry to provide guidance for the treatment of acquisition, exploration and evaluation costs. In Nigeria however, SAS 14, *accounting in the Petroleum industry - Upstream Activities* and SAS 17,

Accounting in the Petroleum Industry – Downstream Activities are the two standards that provide guidance for the treatment of all costs incurred in Oil and Gas exploration and production prior to IFRS adoption.

Most of the IASs issued by IASB have equivalent SASs issued by NASB. However certain standards issued by the NASB do not have equivalent IAS and vice versa. For instance, IAS where no equivalent SAS exist are framework for preparation of financial statements; IAS 14, Segment Reporting; IAS 18, Revenue; IAS 20, Accounting for Government Grants and Disclosure of Government Assistance; IAS 22, Business Combinations; IAS 23, Borrowing Costs; IAS 24, Related Party Disclosures; IAS 27, Consolidated Financial Statements and Accounting for Investment in Subsidiaries; IAS 32, IFRS 7, Financial Instruments: Disclosure And Presentation; IAS 39, Financial instruments: Recognition and Measurement, IAS 36 Impairment of Assets and IAS 41: Agriculture, despite agriculture being the second major source of income in Nigeria. Whereas local standards include SAS 14, accounting in the Petroleum industry - Upstream Activities; SAS 17, Accounting in the Petroleum Industry – Downstream Activities; SAS 16, Accounting for insurance Business; and SAS 20,

Key Accounting Standards in Nigerian Oil and Gas Sector

IFRS 6: Basically, IFRS number 6 deals succinctly on the *exploration for and evaluation of mineral resources*. IFRS 6 is a standard tailored specifically to the extractive industries to provide guidance for the treatment of exploration costs pending the outcome of the wider extractive industries project being executed by the IASB. However, entities transitioning to IFRS are permitted to continue using their current local accounting policy for exploration and evaluation of mineral resources (PWC, 2011). Under IFRS 6, expenditures incurred in exploration activities should be expensed unless they meet the definition of an asset – when it is probable that economic benefits will flow to the entity as a result of the expenditure.

Although, IFRS 6 provides that all expenditures incurred in exploration activities be expensed unless they meet the definition of an asset. However, the treatment of exploration and evaluation (E&E) assets depends on the classification of the asset. Intangible E&E assets may include costs of exploration permits and license while tangible E&E assets may include items of equipment and plants used for exploration activities. IFRS 6 requires entities recognizing E&E assets to perform an impairment test on those assets when facts and circumstances suggest that the carrying amount of the assets may exceed their recoverable amount (KPMG 2012). The impairment should be carried out in accordance with IAS 36 Impairment of Assets once it is identified (Deloitte 2013). However, IFRS 6; exploration for and evaluation of mineral resources is limited in scope and does not provide guidance for the treatment of development and production costs. This implies that IFRS 6, does not go beyond the exploration stage. Companies are therefore, allowed by the IASB to continue using the existing guidance provided by their local standards for the treatment of development and production costs pending the completion of the on-going project being carried out by the IASB regarding the IFRS 6.

Accounting in the Petroleum Industry (Upstream Activities)

This standard was first issued in 1993 by the NASB to enhance the comparability of financial statements prepared by companies operating in the upstream sector of the petroleum industry in

Nigeria (Barde, 2011). The standard basically deals with accounting and reporting for upstream activities which involve the acquisition of mineral interest in properties, exploration (including prospecting), development, and production of crude oil and gas.

Accounting in the Petroleum Industry (Downstream Activities)

This standard provides a guide on accounting practices and reporting formats to be followed by companies operating in the downstream sector of the Nigerian petroleum industry. The standard applies to companies in Refining and Petrochemicals, Marketing and Distribution and Liquefied Natural gas. Downstream activities are activities that take place after the oil and gas has been produced. It involves the receipt of crude oil into crude oil tanks or gas into petrochemical tanks to the transportation of the crude to the refineries, liquefaction of natural gas, refining of the crude oil, marketing and transportation of refined/liquefied products and derivatives to the final user. In the process of crude refining, catalysts are added to the crude in order to speed up the cracking process. IFRS does not have a specific guidance on catalyst (PwC 2011). But the principles of IAS 16 and IAS 2 are used to account for catalysts. Catalysts are expensed as consumed and accounted for as an inventory and recorded at the lower cost or net realizable value (PwC 2011). NG-GAAP requires catalysts to be separated into short-life (lasts less than a year) and long-life catalysts (lasts a year or over). The costs of short life catalysts are expensed in the year in which they are incurred while the costs of long-life catalysts are capitalized and written off over the life of the refinery. IFRS provides that costs of major overhauls of refineries can be capitalized if the useful life of the Property, Plant and Equipment (PPE) gets extended or its productive capacity is increased. SAS17 requires the costs of turn-around maintenance (TAM) to be capitalized and amortized over the expected period before the next TAM. TAM in Nigeria is usually carried after every two years. Costs of spare parts and servicing equipment apart from major spare parts and standby equipment, are usually carried as inventory under IFRS and recognized in the profit or loss as consumed. Major spare parts and equipment qualify as PP&E when an entity expects to use them during more than one period. SAS17 requires standby equipment and spare parts to be capitalized as part of PP&E and depreciated over the expected useful life of similar equipment in use. The costs of refining or petrochemical plant and equipment should be capitalized and depreciated on a straight-line basis over the useful life of the asset.

Oil and Gas accounting methods

There are basically two alternative methods for accounting for acquisition, exploration and development and productions costs in Oil and Gas exploration and Production, viz., Successful Efforts (SE) Method and Full Cost (FC) Method

Successful Efforts (SE) Accounting Method

Under the SE method, generally only those costs that lead directly to the discovery, acquisition, or development of specific, discrete oil and gas reserves are capitalized and become part of the capitalized costs of the cost Centre. Costs that are known at the time of incurrence to fail to meet this criterion are generally charged to expense in the period they are incurred. When the outcome of such costs is unknown at the time they are incurred, they are recorded as capital work-in-

progress and written off when the costs are determined to be non-productive. Under the SE method, the propriety of carrying forward costs incurred and subsequently matching them against future revenues depends on whether a specific cost can be identified with specific reserves. If this direct relationship does not exist, the cost should be charged to expense. If a direct association does not exist between a non-productive cost and reserves found and developed, the cost should not be classified as an asset because it is deemed to not provide future benefits in the form of cash flows. Charging non-productive costs to expense is consistent with the Framework - costs that do not result directly in future benefits are properly charged to expense. If costs related to unsuccessful ventures are not charged to expense, both current and future financial statements are distorted because those costs must eventually be removed from the balance sheet and reported in the statement of profit and loss even though they contribute nothing to future revenues.

Full Cost (FC) Accounting Method

Under the FC method, all costs incurred in prospecting, acquiring mineral interests, exploration and development are capitalized and accumulated in large cost Centre that may not be related to geological factors. The cost Centre, under this method, is not normally smaller than a country except where warranted by major difference in economic, fiscal or other factors in the country. The capitalized costs of each cost center are depreciated as the reserves in each cost center are produced. Under the FC method, all costs incurred at any time and at any place in a cost center in an attempt to add commercial reserves are an essential part of the cost of any reserves added in that cost center. As a result they are directly associated with the enterprise's reserves in that center and all the costs should be treated as part of the cost of the mineral assets in the cost center. Under the FC method, in respect of a cost center, all acquisition costs, all exploration costs and all development costs should be treated as capital work-in-progress when incurred; all costs other than the above should be charged as expense when incurred.

Conclusion and Recommendations

This study has conceptually examined financial reporting in the oil and gas sector. Few local standards that hitherto were applied by firms in the oil and gas sector were evaluated alongside the positions of the International Financial Reporting Standards. Despite the application of these varying standards, it is obvious that firms are not guided in their financial reporting practices. Thus, it is therefore suggested that the financial reporting council of Nigeria should specified specific standards for Nigerian firms in the oil and gas sector to improve their financial reporting practices subject to the IFRS requirements.

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