

Query No. 31

Subject: Presentation of provision for crossflow claim.¹

A. Facts of the Case

1. A public limited company (hereinafter referred to as the ‘company’) which is a wholly owned subsidiary of a listed government company, is in the business of exploration and production (E&P) of oil and gas and other hydrocarbon related activities outside India.
2. The company operates overseas projects directly and/or through subsidiaries, by participation in various joint arrangements and investment in associates. Globally, E&P business is carried out by way of joint arrangements or investments in the form of subsidiaries/associates. The company has adopted Indian Accounting Standards (Ind ASs) w.e.f. 1st April 2016 (transition date 1st April 2015). The functional currency of the company is assessed as US Dollars (USD) in accordance with the provisions of Ind AS. The company presents its financial statements in its presentation currency which is Indian Rupee (INR).
3. The overseas oil and gas operations are generally conducted in joint arrangements with other partners. Main reason for holding mineral rights through jointly controlled entities/subsidiaries is because of host country’s regulations and/or various business considerations (strategic/risk management/financing etc.). The joint partners investing in an oil and gas field are individually known as consortium members and collectively as a consortium.
4. The company explores and produces hydrocarbons from different geographical areas (fields) under its mineral rights. The mineral rights license is granted on the basis of surface area divisions whereas hydrocarbon reserves are subsurface formations and can be conjoined in some cases. The hydrocarbon bearing fields are mostly tightly packed formations and there could be cases where two adjacent fields are operated by two separate parties having control over mineral rights of their respective fields. In such cases, there is a possibility of flow of hydrocarbons from one field to another adjacent field. Due to conjoined reserves, different pressure levels could cause oil and gas to flow from one reserve to another reserve. This phenomenon is inherent to the nature of upstream oil and gas industry and is known as ‘crossflow’.
5. The querist has stated that in one such field of the consortium of which the company is a partner (consortium member), the operator of an adjacent field has claimed crossflow of oil and gas from that adjacent field to the consortium’s field. On the basis of a preliminary estimate of the claim, the company has made a provision of part amount and the balance amount was shown under the contingent liability.
6. The company has classified the above-mentioned provision made against the crossflow settlement, as a separate line item in the notes under the head ‘Provisions, write-off and other impairment’ in the statement of profit and loss treating it as a provision in accordance with Ind AS 37, ‘Provisions, Contingent Liabilities and Contingent Assets’.
7. During the course of Government audit, it was highlighted by the Comptroller and Auditor General (C&AG) team that the said provision is an exceptional item and should be shown on the face of the statement of profit and loss under the head ‘Exceptional Items’ and profit after exceptional items would be arrived at accordingly.
8. According to the querist, the term ‘Exceptional Items’ is neither defined in Ind AS Schedule III to the Companies Act, 2013 nor in any Ind AS. However, Ind AS 1, ‘Presentation of Financial Statements’ has references to such items in paragraphs 85, 86, 97

¹ Opinion finalised by the Committee on 8.1.2019.

and 98. Paragraph 85 provides for presenting additional line items in the statement of profit and loss if it is relevant for understanding of entity's financial performance and paragraph 86 stresses on materiality and nature and function of income/expense. Paragraph 97 is more relevant and states that, "*When items of income or expense are material, an entity shall disclose their nature and amount separately*". Paragraph 98 of Ind AS 1 gives an illustrative list where separate disclosure is required. The said list comprises of events that are non-recurring or at least non-frequent in nature. (Emphasis supplied by the querist.)

9. The querist has further stated that paragraph 12 of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' states that when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

10. Thus, from a collective reading of above provisions, it can be concluded that following ingredients should be there for an item of income/expense to be regarded as 'exceptional items':

- a. The items should arise from ordinary activities;
- b. They are not expected to be recurring in nature;
- c. The nature and amount of such item is material to the financial statement in best judgement of the management of entity to enable the users of financial statements to understand its financial performance.

11. Crossflow of hydrocarbons from one field to another is related to the ordinary activities of the company but they are of recurring nature though the frequency of settlement of claims arising therefrom depends upon the arrangement amongst the parties. The phenomenon of crossflow is intricately linked with the core nature of upstream E&P business where fields are conjoined. *Such crossflows are therefore normal in oil and gas industry and adjustments have to be made on a regular basis.* In our case, a draft agreement has been formulated wherein the crossflow of oil and gas is proposed to be reviewed after every 5 years. Therefore, it can be reasonably concluded that this transaction will be occurring on a frequent basis in the financial statements of the company. (Emphasis supplied by the querist.)

12. As regards 'materiality', the querist has referred to paragraph 7 of General Instructions for Preparation of Financial Statements of a Company required to comply with Ind AS of Division II- Ind AS Schedule III to the Companies Act, 2013, which defines material items as the items that could individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size or nature of the item or a combination of both, to be judged in the particular circumstances. According to the querist, *in the instant case, neither the size nor the nature of the transaction indicates conditions for being considered as 'material' to the financial statements of the company.* (Emphasis supplied by the querist.)

13. As per the querist, absence of a clear definition of 'exceptional items' in Ind ASs and availability of broad guiding principles only to assess the nature of any transaction, places the onus of assessing and deciding the nature of transaction on the management of the entity. Therefore, *the intent of Ind AS is to rely on the management of the entity to use its best judgement to ascertain the classification of any item as exceptional items in the financial statements as per the nature of industry in which the entity operates, size and nature of transaction and its impact on the user's readability of the financial statements.* (Emphasis supplied by the querist.)

14. As explained above, the provisions made by the company in respect of crossflow claim of the operator of adjacent field are normal in nature and are regular phenomena of the E&P industry. Further, the amount of provision made is not also material to warrant a separate line item on the face of the statement of profit and loss. The company has shown the said provision as a separate line item under the head 'Provision, write-off and other impairment' and has also provided a disclosure note under contingent liability in respect of the said provision explaining the nature of the transaction in detail to assist the users of the financial statements to comprehend the nature of provision made.

15. Therefore, in the considered opinion of the querist, the provision made in respect of the claim for crossflow of hydrocarbons is a normal and regular feature of the E&P industry and, therefore, should be out of the purview of 'exceptional items'.

B. Query

16. In view of the above facts, the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India is sought on the following issues:

- (i) Whether the provision made by the company against the claim of operator of adjacent field in respect of crossflow of oil and gas has been correctly shown by the company under the head 'Provisions, write-off and other impairment' considering the intricate link of such phenomena with the E&P industry and the size and nature of amount involved;

or

- (ii) Whether the said provision comes under the ambit of 'exceptional items' and is supposed to be shown as a separate and additional line item under exceptional items in the statement of profit and loss.

C. Points considered by the Committee

17. The Committee notes that the basic issue raised by the querist relates to presentation of provision for crossflow claims, viz., whether the same should be presented under the head 'Provisions, write-off and other impairment' or the same should be considered as an exceptional item and should be disclosed on the face of the statement of profit and loss under the head 'Exceptional Items'. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, recognition and measurement of provision for crossflow claims, accounting for inventory in respect of crossflow, appropriateness of disclosure made under contingent liability in this regard, appropriateness of inclusion of other items under the head 'Provisions, write-off and other impairment', etc. Further, the opinion has been expressed in context of Indian Accounting Standards (Ind ASs) notified under the Companies (Indian Accounting Standards) Rules, 2015 (hereinafter referred to as 'the Rules').

18. The Committee notes that Part II of Division II of Schedule III to the Companies Act, 2013 (hereinafter referred to as the 'Ind AS Schedule III'), which prescribes the format of statement of profit and loss applicable for companies adopting Ind ASs, requires presentation of 'Exceptional Items' as a separate line item in the statement of profit and loss. Further, Note 7 of the 'General Instructions for Preparation of Statement of Profit and Loss' applicable for companies adopting Ind ASs requires that a company should disclose by way of notes, additional information regarding aggregate expenditure and income on some items. One of the items to be disclosed in this regard is 'details of items of exceptional nature'. However, the term 'exceptional item' is not defined in 'Ind AS Schedule III'. Further, the term 'exceptional item' is neither defined nor used in Ind ASs.

19. The Committee also notes the following paragraphs of Indian Accounting Standard (Ind AS) 1, 'Presentation of Financial Statements', notified under the Rules:

“31 Some Ind ASs specify information that is required to be included in the financial statements, which include the notes. An entity need not provide a specific disclosure required by an Ind AS if the information resulting from that disclosure is not material except when required by law. This is the case even if the Ind AS contains a list of specific requirements or describes them as minimum requirements. An entity shall also consider whether to provide additional disclosures when compliance with the specific requirements in Ind AS is insufficient to enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.”

“85 **An entity shall present additional line items (including by disaggregating the line items listed in paragraph 82), headings and subtotals in the statement of profit and loss, when such presentation is relevant to an understanding of the entity's financial performance.**”

“86 Because the effects of an entity's various activities, transactions and other events differ in frequency, potential for gain or loss and predictability, disclosing the components of financial performance assists users in understanding the financial performance achieved and in making projections of future financial performance. An entity includes additional line items in the statement of profit and loss, and it amends the descriptions used and the ordering of items when this is necessary to explain the elements of financial performance. An entity considers factors including materiality and the nature and function of the items of income and expense. For example, a financial institution may amend the descriptions to provide information that is relevant to the operations of a financial institution. An entity does not offset income and expense items unless the criteria in paragraph 32 are met.”

“97 **When items of income or expense are material, an entity shall disclose their nature and amount separately.**

98 Circumstances that would give rise to the separate disclosure of items of income and expense include:

- (a) write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;
- (b) restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;
- (c) disposals of items of property, plant and equipment;
- (d) disposals of investments;
- (e) discontinued operations;
- (f) litigation settlements; and
- (g) other reversals of provisions.”

Further, the Committee notes that the term 'material' is defined in paragraph 7 of Ind AS 1 as below:

“Material Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on

the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.”

20. From the above, the Committee notes that subject to legal requirements, material items need to be presented as line items and/or disclosed in financial statements, which includes the notes. Further, as per the requirements of paragraphs 85 and 86 of Ind AS 1, events and transactions which differ in frequency should be presented as additional line items/headings when such presentation is relevant to understanding of the entity’s financial performance. The Committee also notes that Question No. 32 of the Educational Material on Ind AS 1, issued by the erstwhile Ind AS Implementation Committee of the ICAI on the meaning of ‘Exceptional items’ states that, “it appears that all material items are not exceptional items and exceptional items are those items which meet the test of ‘materiality’ and ‘incidence’ ”. Definition of the term ‘Material’ as per paragraph 7 of Ind AS 1 is reproduced in paragraph 19 above. The Committee is of the view that ‘incidence’ refers to frequency of occurrence.

21. In the above context, the Committee notes that the querist has stated in paragraph 14 and 20 above that the provision made by the company in respect of crossflow claim is a regular phenomenon of the E&P industry and the amount involved is not material. In this context, the Committee notes from the copy of the provisional comments of C&AG (separately provided by the querist for the perusal of the Committee) that the C&AG has commented that the amount of provision is 15% of the profit after tax for the year 2017-18 and therefore it is material whereas management has replied that as the provision is less than 1% of the consolidated revenue of the company, the same is not deemed material. Further, the Committee also notes from the standalone and consolidated financial statements of the company for the financial year 2017-18 that the amount of provision (Rs. 644.73 million) is 11.25% (approx) and 7.77% (approx) respectively of the profit before exceptional items and tax (Rs. 5732.91 and Rs. 8290.47 million respectively). The Committee is of the view that the impact on profit before tax is also an important factor to be considered for determination of materiality. In this regard, the Committee further notes from paragraph 7 of Ind AS 1, reproduced above, that an item should be considered material if it can influence the economic decisions of the users and that materiality depends on both size and/ or nature of an item. Thus, considering the size of this expense item in relation to profit before exceptional items and tax, the Committee is of the view that it is material and the company should comply with the disclosure requirements of paragraphs 97 and 98 of Ind AS 1. However, both the materiality and incidence tests are required to evaluate whether an item is exceptional or not and in this case, even though the item is material, same is regular item, as asserted by the management of the company. Consequently, based on the above discussion, the Committee is of the view that in the extant case, provision made by the company in respect of crossflow claim is not an exceptional item and need not be shown on the face of the statement of profit and loss; the same should however be disclosed as per the requirements of Ind AS 37. However, in case, it meets the ‘materiality’ and ‘incidence’ test, the company should disclose the same as ‘exceptional item’.

D. Opinion

22. On the basis of the above paragraphs, the Committee is of the opinion that the disclosure of provision made by the company in respect of crossflow claim appears to be appropriate. However, this being material should be disclosed as per paragraphs 97 and 98 of Ind AS 1.