The Impact of the Petroleum Industry Act on Deferred Tax Recognition Under IAS 12

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Contents

The enacted Petroleum Industry Act (PIA) introduced changes to the fiscal framework applicable to the Nigerian Petroleum Industry, some of these changes will have an impact on the measurement and recognition of deferred taxes in the relevant entities[1].

Some of the significant changes emanating from the PIA worth noting from a deferred tax perspective includes the following:

1

The Decommissioning and Abandonment Fund

Section Section 233 of the PIA mandates each lessee and licensee operating in the downstream, mid-stream and upstream sub-sectors to set up, manage and maintain a decommissioning and abandonment fund held by a financial institution that is not an affiliate of the lessee and licensee, in the form of an escrow account. The decommissioning and abandonment fund would be used to settlement their obligations towards the restoration of sites after assets retirement and abandonment.

Previously, lessees and licensees only made provisions for the obligations arising from asset retirement pending the crystallization of the obligation but given the requirements of the PIA, they must set aside funds to meet these obligations when they arise. The question arises as to how these funds might be accounted for.

Accounting for the decommissioning and abandonment funds

The funds are to be held in a separate legal entity and the contributor's right to access the funds is restricted. Hence, the funds fall within the scope of IFRC 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*. Paragraph 7 of IFRIC 5 requires a contributor to recognise its obligation to pay decommissioning costs as a liability and recognise its interest in the fund separately unless the contributor is not liable to pay decommissioning costs even if the fund fails to pay. Section 26(4) of the Midstream and Downstream Decommissioning and Abandonment Regulations, 2023 gazette clarifies that where the Fund is not sufficient to cover the decommissioning and abandonment expenditure, the licensee shall cover such difference to fulfil the obligations in full. Hence the funds meet the requirements of paragraph 7 of IFRIC 5.

The fund is designed to help contributors meet their decommissioning or rehabilitation obligations. Since contributors have no control, joint control, or significant influence over the fund, they recognize the right to receive compensation from the fund as a reimbursement right, in accordance with IFRIC 5.9. In other words, the provision for Asset Retirement Obligations (ARO) currently recorded in the books will remain unchanged. The fund will be recorded separately as an asset and will not be used to reduce the provision since the obligation has not yet been settled. The obligation will only be extinguished once the site is restored and payment has been made for the restoration.

Changes in the carrying value of the right to receive reimbursement other than contributions to and payments from the fund shall be recognised in profit or loss in the period in which these changes occur. Hence, the interest accrual on the funds would be recorded in the profit or loss account and the carrying value of the fund would be increased by the amount of the interests accrued.

Impact on the deferred tax computation

In the deferred tax computation, the accounting base[2] would be the carrying amount of the fund asset on the balance sheet. From a tax perspective, the annual contributions are deductible in the fiscal year that they were contributed and disbursements from the fund to settle the asset retirement obligation shall not be tax deductible. This implies that the tax benefit was utilized when the amount was contributed and will no longer have an impact on the future tax liability of the entity, so the tax base[3] is zero. Therefore, there is a difference between the accounting base of the asset and the tax base; however, this difference will reverse when the fund is disbursed to pay for the ARO liability (i.e. the fund asset is reduced to zero), at which point the disbursements will not be tax deductible, so there is no deferred tax.

The Midstream and Downstream Decommissioning and Abandonment Regulations gazette clarifies in Section 24 (8) that interests accrued on the funds would form part of the funds and so form part of the accounting base. From a tax perspective, since the interest forms part of the fund, it is expected that the interest would reduce the amount of deductions made in the future and would therefore be non-taxable[4].

[1] Relevant entities refers to licensees or lessees operating in the upstream, midstream or downstream sectors under the Petroleum Industry Act.

[2] The accounting base of an asset or a liability is the carrying amount of that asset or liability on the balance sheet.

[3] The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its' carrying amount.

[4] The regulations do not explicitly cite this position and it has not been tested.

Notwithstanding the above, a deferred tax had previously arisen from the difference between the ARO asset (in Property, Plant and Equipment) and the ARO liability, this deferred tax would be reduced to the extent of the balance of the fund asset (contributions and interest accrued) because the tax benefit arising from the difference between the ARO asset and the ARO liability was utilized when the contributions were allowed for tax purposes and there is no future tax benefit accruable to that portion of the ARO liability.

(See illustrative example on page 6)

It is important that preparers are aware of the requirement of paragraph 53 of IAS 37, which stipulates that the amount recognised for the reimbursement shall not exceed the amount of the provision; therefore, any excess of the fund over the ARO liability would be recognized as a separate asset.

2

Restriction of total cost to 65% of revenue

Section 266 (2) of of the PIA requires that in determining the chargeable profit for HCT, the total cost (i.e. total claimable costs including capital allowances) shall not exceed the cost-price ratio limited to 65% of revenue. Where there is an excess over the limit, that excess can be carried forward and utilized in subsequent fiscal years.

Impact on the deferred tax computation

There is no accounting base for this item as it will not exist on the balance sheet of the entity; however, it has future economic value from a tax perspective since it is deductible in the future so there would be a tax base equal to the excess that is carried forward. Hence, there is a deferred tax impact. This provision introduces a new deferred tax element.

3

Treatment of unused investment tax allowance (ITA) and investment tax credit (ITC)

According to Section 317(4) of the PIA, for converted licenses of entities with Production Sharing Contracts, Investment Tax allowances and Investment Tax Credits shall not be caried forward from the oil mining leases to the petroleum mining leases.

Impact on the deferred tax computation

Entities with Production Sharing Contracts (PSC) who have unused ITA and ITC brought forward would have recognized deferred tax on them in prior years. The previously recognized deferred tax would be derecognized since the unused ITA and ITC would no longer have any future tax benefit.

4

Change in tax status

The conversion of contracts from the Petroleum Profits Tax Act (PPTA) to PIA introduces a change in tax status, this change will impact the amount of the tax base for certain transactions and the tax rate. According to Section 92(4) of the PIA, a conversion contract shall be concluded at a date (conversion date) which is the earlier of 18 months from the effective date and the expiration of the oil mining lease or the date of the conversion of the oil prospecting license to an oil mining license. Section 92(5) goes on to state that prior to the conversion date, the terms applicable to the oil prospecting licence or oil mining lease prior to the effective date shall continue to apply.

Impact on the deferred tax computation

In measuring deferred taxes, IAS 12 *Income Taxes* requires that entities use the rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. Section 92(5) indicates that the PPTA rate applies until the license is renewed, when the licenses are renewed, the rates stated in the PIA applies. The question arises as to when one can apply the requirements of the PIA in computing deferred tax considering that the assets will be realized and liabilities settled in the future. The standard does not specifically address what to do in this situation but looking at the requirement, we are of the view that the entity should carry out an assessment to determine when the temporary difference arising from the asset or liability would reverse in determining which rate to use. This approach makes it possible that different elements of the deferred tax will be measured using different rates. For instance, if XYZ Limited anticipates that it would renew its license in 2 years' time, it might estimate that the obligation on assets retirement and abandonment would be settled in twenty years, long after it has renewed its license. The Tax Written Down Value (TWDV) of some of its machinery could be fully utilized in a year and a half based on the remaining estimated useful life of the assets. In this instance, in the deferred tax computation, the tax rate of the PPTA would apply to the machinery but the tax rate of the PIA would apply to the assets retirement obligation. This will relate to the part not yet funded and to the extent that it will not be funded before the change.

The assessment of the timing of the reversal of temporary differences would require significant judgement and estimates which would have to be disclosed in the financial statements in line with paragraph 125 of IAS 1 *Presentation of Financial Statements.*

5

Timing of conversion where conversion happened during the financial year

Licensees and lessees who converted on the 16th of February 2023 are in a situation where they must apply both the PPTA and the PIA in the first year of application. The deferred tax is computed from a balance sheet perspective so what is crucial is what we have at the end of the year i.e. at balance sheet date. Hence, we would compare the amounts on the balance sheet to their tax base to determine the temporary differences. The tax base will be determined based on the requirements of the PIA and CITA. The applicable tax rate would be that of the PIA and CITA.

Conclusion

The requirements of the PIA would have a significant impact on deferred tax computations. Certain aspects of the computation require significant judgment and models to forecast when different assets would be realized and liabilities settled would have to be built or updated. Stakeholder engagement needs to commence early as the numbers would be different from what they were in the past. It is important that auditors are carried along and if necessary, help should be sought from a professional accountant.

Illustrative example

In the 2023 financial year, Company K, an Exploration and Production company, contributed $100million to the decommissioning and abandonment fund. In the year, the fund generated interest of $10million. The NBV of the ARO asset in PPE was $89million while the ARO liability was $145million. The company records the transactions as follows:

	Debit	Credit
Other assets: Decommissioning and abandonment fund	100 million	
Bank balance *(To recognize contribution to the fund)*		100 million
Other assets: Decommissioning and abandonment fund	10 million	
Profit/loss : Interest income *(To recognize interest earned on the fund)*		10 million

On computation of the deferred tax:

	Carrying amount	Tax base	Temporary difference	Tax rate	Deferred tax
Decommissioning and abandonment fund:					
Contribution Interest earned	100 million 10 million	- -	100 million 10 million		
ARO Asset **ARO Liability**	89 million (145) million	- -	89 million (145) million		
Net impact	54 million		54 million	63%*	34.02 million

**The tax rate of 63% is the result of the addition of the Hydrocarbon tax rate of 30%, CIT tax rate of 30% and Tertiary Education tax rate of 3%.*

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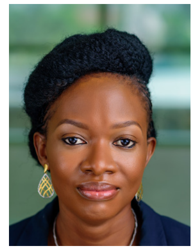

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