

These Procedures set out what is generally regarded in the Industry as good practice. They are not mandatory and Operators may adopt different standards in a particular situation where to do so would maintain an equivalent level of reporting. Where there is an inconsistency with the Accounting Procedure, the Accounting Procedure will prevail.

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1. Introduction

This document provides guidance on recommended accounting practices to ensure accounting for materials and inventory is on a 'fit for purpose' basis using the rationale that materials is either useable or it is not. This Procedure is also intended to describe and encapsulate current best practice in Accounting for Materials.

2. Explanation

Many existing Joint Operating Agreements (JOA) and Unit Agreements state that material transferred to joint operations accounts from Operators or any of their affiliates is valued on the basis of condition codes. New Material is valued on a Condition 'A' basis (lower of cost or current market value) and used material takes a continuum of Codes B to E (75% value to nil) based on its condition. This has been found to be cumbersome to operate, inconsistent, open to subjective interpretation and difficult to standardise. In its place, a simplified system has been adopted in practice based on a determination as to whether inventory is 'fit for purpose' or not.

Management of materials should always be in line with JOA agreements and comply with JV approval thresholds.

The Operator has an obligation, under good oil and gas field practice, to ensure the safe custody of materials. The Operator shall periodically advise all Co-ventures of its program of physical stock takes both onshore and offshore. Co-venturers should have the right, upon giving prior written notice to the Operator, to attend one or more physical stock takes and to review the associated verification, and any resulting adjustment, of the accounting records of the stock so counted. Reconciliation should be made between the inventory listings and the records of stocks held on the Joint Account and a list of surpluses and shortages should be determined by the Operator. Inventory adjustments should be made by the Operator to the Joint Account for surpluses and shortages, with relevant explanations where available.

3. Accounting Procedure

3.1 Material purchased and supplied by Operators or their affiliates which is intended to be used on the joint operations should be 'fit for the purpose'.

3.2 Material which is 'fit for purpose' should be accounted for at the moving average value for the particular item or class of inventory. If the current stock module doesn't allow for this then purchase price should be used. If that is not available then the vendor should provide the current market value to be used.

3.3 New material purchased from third parties should continue to be valued at cost, which shall mean net invoice price (after deducting all trade and cash discounts actually received), together with transport costs, forwarding and documentation fees, packing costs, duties, licence fees, non-recoverable taxes and like items chargeable. This cost will affect the moving average value for the respective items of inventory.

3.4 Material which is **not** 'fit for purpose' and deemed to be scrap should be carried at nil value/ penny value and marked as damaged in the stock module with any values recompensed upon disposal being credited to the last operation that bore the cost of the material.

3.5 The same criteria applies to returned materials:

- Material which remains 'fit for purpose' after use should be returned to inventory at moving average value; or other value as stated in 3.2
- Material which, after inspection, is deemed **not** to be 'fit for purpose' should be accounted for at nil / Penny (scrap) value, the cost of the material to be borne by the user/licence;
- Material which is subject to inspection and repair should be returned to inventory at moving average value **after** repair;
- Cost of inspection and repair to be borne by the user/licence. Subsequently, if the item goes to a new

owner the item should be transferred at moving average or alternative method as per 3.2

- The Operator's inventory records should note the customs status against each line item. Given that import duty may be payable on goods with "End Use" customs status which are not used within a time-limited "throughput period", the Operator's processes and controls should be geared towards using End Use inventory items first wherever possible. Partners should not be liable for import duty costs incurred as a result of poor monitoring and control by the Operator in this regard.
- For rockbits, special rules may apply as these are generally treated as consumables. The purchase cost of the rockbit should be applied to the initial user licence. If the rockbit is used subsequently on another licence, it may be transferred at nil value, but the cost of refurbishment, if applicable, will be borne by the next user licence.
- If the rockbit is purchased but unused by the initial user licence, and the rockbit is subsequently used on another licence, it should be transferred at the full purchase cost
- If the rockbit used on two licences then the third licence gets rockbit FOC.

3.6 Bulk materials left on drilling rigs at the time of transfer of user should be valued at the cost to the initial purchaser and transferred on a FIFO usage basis not a last purchase price (example below). In certain circumstances, having regard to the commerciality of the transaction and where it is agreed by the parties, current market values may be substituted for cost to the initial purchaser. The same rules apply, as noted above, for bulk materials deemed to be **not** 'fit for purpose'. This example is for multi venture drilling Operations.

FIFO usage example

Transaction	Date	MT	£/MT	Total £	Comments
Delivery	01/03/2020	280	£ 450	£ 126,000	All fuel used
Delivery	15/03/2020	300	£ 400	£ 120,000	202MT Used / 98 MT unused ROB
Delivery	30/03/2020	350	£ 270	£ 94,500	350 unused ROB
		930			
Usage	Mar-20	482			
ROB (Remaining on Board)	01/04/2020	448			

Transfer to next well based on FIFO usage	01/04/2020	350	£ 270	£ 94,500
		98	£ 400	£ 39,200
Total transfer		448	£ 298.44	£133,700

Transfer to next well based on last fuel bunker	01/04/2020	448	£ 270	£ 120,960
Total transfer		448	£ 270.00	£120,960

Material difference				£ 12,740
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3.7 Transfers of inventory between licences should be made at the moving average value (**except** in exceptional instances as noted below) as it is 'fit for the purpose'.

- Market values or current replacement values may be substituted for moving average value where, having regard to the commerciality of the transaction;
 - it is agreed by the parties; and
 - use of moving average value will be disadvantageous to the parties.

The commerciality of the inventory transfer can be affected by all or some of the following components:

- Current value in system;
- Current market or replacement value;
- Delivery times for replacement inventory;
- Licence/venture requirement, which is defined as a need arising within a foreseeable timeframe, usually one year.

These factors will influence the decision to use either the average stock price in the system or utilise the current market or replacement value for the transfer.

Co-venture agreement, where applicable, will also be required for inventory transfers which exceed the minimum limit imposed by the relevant Joint Operating Agreement (see section 3.13)

- 3.8** Insurance Spares will be carried by Operators to meet emergency needs. These items of inventory are deemed to be critical and their accounting treatment should be in accordance with the Operators' accounting policies. Insurance Spares are defined as high cost items which are held in the unlikely event of a breakdown and purchased at the construction stage of an asset's development. They may never be used and are held as a precaution. A critical spare is a piece of equipment which is essential to obtain at short notice and may not always be a high value / large nature but is required to maintain ongoing Production continuity.
- 3.9** Provisions for obsolescence and disposal may be applied to slow moving inventory. 'Slow moving' may be defined as inventory with a nil turnover over 24 months. Note: This does **not** apply to Insurance Spares or critical spares (see section 3.8)
- 3.10** In some cases, Operators maintain a system of Common Field Inventories i.e. inventory which may be applied to all or several licences and which is normally held as part of the Operator's common warehouse stocks. Transfers from such common inventories will attract a financing charge IF the inventory is NOT to be replaced; such charge reflecting the cost to Operators of maintaining the inventory. The consequent value of inventory may be computed using a formula which contains all or some of the following components:
- Moving average value (values amended for each addition of stock);
 - Financing charge, usually equal to a percentage rate above SONIA (percentage rate to be agreed as part of the financial parameters in the Accounting Procedure);
 - Stock Turnover. Amount of stock used in any period, normally one year. This turnover will be restricted to specific or groupings of inventory, to eliminate the skewing effect of slow moving/damaged/obsolete materials.

It should be noted that chemicals and gas oil are excluded from these calculations.

Surplus inventory returned to Common Field stocks shall generate a financing credit calculated as set out above. In the event that such inventory is to be replaced then the value transferred is the Cost price incurred to replace that inventory, as defined in section 3.3;

It may be noted that instances of application of this paragraph may be very limited as costs of maintaining large inventories are prohibitive and thus operating procedures should discourage and preclude companies from building such volumes of inventory.

- 3.11** Inventories may be maintained at third parties, in which case the following rules apply:
- Stocks held at third parties, to which Operators have ownership, should be included within the overall value of the respective Inventory. Operators are encouraged to avoid having materials tracked offline from the integrated business systems.
 - The **same** valuation rules apply as heretofore stated; -
 - Proper controls over inventory movements to/from third party stockists should be maintained, with appropriate audit trails for all stock values, issues and returns;

- Third parties should report monthly to Operators, opening and closing balances, together with issues and returns of material.

- 3.12** It is recommended that Operators introduce a system under which inventory held at third parties is subject to periodic review and inspection. Regularity of review will be made having regard to the respective values of the inventories concerned.
- 3.13** The value limits (individual and aggregate) under which Co-venture approval for disposal of inventory, including transfers to their Operator ventures in the UK or overseas, is required are set in the relevant paragraph of the respective Accounting Procedure. Unless otherwise agreed by the relevant Joint Operating Committee, the value ascribed to surplus inventory either purchased by the Operator or sold to its Co-venturers shall be the moving average value described in 3.2 above. In cases where surplus inventory is sold to the open market, Operator should prepare a list of items for sale and competitive bids invited from third parties, unless the nature of value of the item makes tendering impracticable or uneconomic. Inter-Licence transfers of inventory are treated as equivalent to a disposal for the purposes of the Joint Operating Agreement (see section 3.7)
- 3.14** A transparent process should be in place for the review and disposal of inventory that is in surplus at the completion of a capital project, often described as 'project inventory'. Included in this process should be a suitable procedure to ensure that only duly approved project inventory passes into the Operator's standard inventory. Such materials that are sanctioned for transfer to standard inventory should be transferred into the Operator's standard stock at the 'fit for purpose' value. The transfer should be made commensurate with the time the project becomes live and operating costs are incurred. The relevant credit should be made to the original project. The remaining capital projects items which are not being transferred to standard inventory should be monitored and controlled by the Operator and historic purchase prices should be noted for each item in case of potential transfer to other ventures or sale to third parties.
- 3.15** It is recommended as good practice that certain high value materials should be serially controlled and uniquely tracked on the Operator's ERP system. These include such materials as Xmas Trees; Completion assemblies and rockbits. For each Operator it depends on the ERP system they use whether this can be done, but any improvements it is recognised should only be at minimal investment due to the life cycle and cost pressures the UK oil and gas sector faces.

4. Impairments

It is recommended that an annual inventory review for both project specific items (included in AFE) but also general inventory held in the inventory accounts should also be undertaken and communicated to Partners, for them to consider including in their own accounts should they wish to do so.

5. Application

This procedure sets out what is generally considered to be best industry practice. In the event that any particular Operator departs from this procedure, it is recommended that such exceptions are appropriately notified to the respective Partners.

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