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A Comparative Analysis of Accounting Procedures in Iran's Upstream Oil and Gas Contracts and the Model Accounting Guidelines of International Petroleum Associations in Joint Operating Agreements

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Highlights

- Introduces a new cost classification framework in Iran's upstream oil contracts to enhance transparency.
- Compares domestic accounting practices with international standards applied in joint operating agreements.
- Improves cost clarity through the application of "no profit, no loss" reimbursement principles.
- Proposes practical measures to reduce overhead expenditures and mitigate auditing disputes.

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Abstract

One of the principal challenges facing regulators of oil contracts in Iran concerns the financial and taxation framework and the auditing procedures governing such contracts. This issue has remained a persistent concern for oil-sector stakeholders, both before and after the Islamic Revolution. With the adoption of the service contract model as the sole approved contractual template in upstream oil operations, oil companies—acting as contractors—undertake investment in petroleum activities and, upon achieving the contractual objectives, become entitled not only to reimbursement of their costs but also to the receipt of contractual fees. In accordance with the "no profit, no loss" principle, and to prevent contractors from unjustly benefiting through the overstatement of incurred expenses, the parties classify costs and, applying established accounting and auditing principles, define the nature, components, and calculation methods of those costs. Given Iran's increasing need to conclude Joint Operating Agreements (JOAs) aimed at facilitating technology transfer and enhancing reservoir recovery—by assigning operational responsibilities to an Iranian operating company while preserving the contractor's overall responsibility—it has become essential to revise and adapt Iran's accounting and auditing procedures to meet the specific requirements of such agreements. In this context, the model accounting procedures developed by international petroleum associations can serve as practical and effective benchmarks for reform.

Keywords: Accounting procedures, Categories of expenses in upstream contracts, Financial system, Capital expenditure, Operating cost

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1. Introduction

The oil industry is widely recognized as one of the most capital-intensive sectors globally, characterized by substantial cash-flow turnover. This condition—combined with the presence of numerous stakeholders, differing perspectives, and varying contractual arrangements—necessitates organized and systematic cost management. On one hand, the complexity and operational challenges associated with exploration, extraction, and production activities, and on the other, Iran's need for technical knowledge, expertise, and financial resources in its engagements with international oil companies, have historically created a conflict of interests between Iran as the host state and the foreign contractor. Under such circumstances, the financial regime, methods of expenditure, and benefit-sharing mechanisms become critically important.

In Iran's current upstream oil contracts, expenditures are categorized into four groups to ensure accurate cost determination: direct or capital costs, indirect or non-capital costs, banking costs, and financial costs. Since the classification of each cost item and the preparation of related accounts play a decisive role in maintaining contractual balance and equilibrium, the parties incorporate specific accounting procedures into their agreements. Moreover, in most upstream contracts, the need for concise drafting leads to the inclusion of detailed accounting rules in an annex, where cost definitions, methodologies, and reporting requirements are elaborated. The overarching purpose of adopting accounting procedures in oil contracts is to establish fair and transparent methods for recording, preparing, and reporting costs and credits associated with petroleum operations. Achieving this objective ensures that cost reimbursement and fee payments are executed in accordance with the "no profit, no loss" principle.

Regarding the research background on financial systems in petroleum contracts, the long-term nature of such agreements typically leads to increased expenditures and the emergence of various risks, rendering cost reimbursement more complex. Consequently, costs incurred by the employer are distributed and allocated into distinct categories, the definition and rationale of which have been discussed in academic and research publications (Ebrahimi and Ghasemi Moghadam, 2014: 27–58).

This article employs an analytical-descriptive methodology, drawing on library research and relevant legal documents, to examine the financial framework of Iran's upstream oil contracts. It provides a detailed analysis of the cost classification system and the accounting procedures governing these agreements, seeking to answer the central question: What is the structural model of accounting procedures in Iran's upstream petroleum sector? The study also addresses a complementary question: What should constitute an appropriate accounting and auditing framework for Joint Operating Agreements in Iran's oil and gas industry?

Finally, given Iran's expanding reliance on Joint Operating Agreements—particularly for developing shared fields and facilitating technology transfer to enhance reservoir recovery—the article aims to propose practical recommendations for improving accounting practices. This is achieved through a critical assessment of the model accounting procedures for joint operations as developed and published by leading international petroleum associations.

2. Financial regime and categories of costs in Iran's upstream oil contracts

A significant role is played by the financial system in oil contracts, given that petroleum is regarded as a strategic commodity in many countries, including Iran, and is considered a guarantor of public welfare. It is this financial system that determines how the proceeds and revenues generated from the

execution of the contract are allocated between the oil-owning state and the international oil company. Moreover, one of the key distinguishing features among various types of petroleum contracts lies in their financial systems and the taxation frameworks imposed upon them (Rostami & Binaei Bashi, 2022, p. 85). Accordingly, the financial system must be structured so that, on one hand, it incentivizes international oil companies to undertake greater investment, and on the other hand, it reduces the costs associated with petroleum operations. Situating the evolution of oil contracts within the historical context of Iran's petroleum legal system can therefore enhance our understanding of current cost classifications and accounting procedures in Iran's upstream contracts.

Following the enactment of the 2011 Amendment to the Oil Law and the Law on the Duties and Powers of the Ministry of Petroleum, a new order was introduced into the country's petroleum contractual regime. As a result, the Oil Law of 1974 was explicitly repealed, and according to Article 7 of the Law on the Duties and Powers of the Ministry of Petroleum, "the general terms of oil contracts shall be approved by the Cabinet upon the proposal of the Minister of Petroleum." To date, the only contractual framework ratified by the Cabinet has been the General Terms, Structure, and Model of Upstream Oil and Gas Contracts, under which the Iranian Petroleum Contract (IPC) model is concluded. The IPC model, whose draft was approved by the Cabinet in 2015, was formally adopted in 2016 (Kazemi Najafabadi & Naseri, 2019, p. 671).

The financial system governing Iran's upstream contracts follows a risk-service model, and petroleum-related costs are broadly categorized based on the nature of expenditure. In certain texts, distinguishing clearly between these categories may be difficult, as such differentiation often depends on the organizational and structural features of the project. Nonetheless, pursuant to Sections "S" to "Z" of the General Terms and Model of Upstream Oil and Gas Contracts ratified by the Cabinet, petroleum costs are classified into four main categories: capital (direct) costs, indirect costs, operating costs, and banking costs. The various cost categories arising from petroleum operations will be discussed in the following section.

2.1. Capital or direct costs

Capital or direct costs are defined as all expenses incurred by the contractor in connection with petroleum operations for the purpose of achieving both initial and final production of crude oil and natural gas. These expenditures arise, as applicable, from activities related to field evaluation, exploration, development, and production, as set forth in the approved work program and budget. In other words, capital costs encompass service-related expenditures or the costs of durable assets incurred prior to the commencement of production or, when necessary, after production has begun (Ebrahimi and Ghasemi Moghadam, 2014: 27–58).

Generally, this category of costs includes engineering expenses; reservoir improvement and enhanced recovery expenditures; and management costs associated with engineering development activities, design, drilling, and the construction of all required surface and subsurface facilities for field development. It also includes processing plants, transportation and injection facilities, processing installations, and all commissioning activities related to these units, as well as costs associated with major maintenance, major repairs, and modernization of field and reservoir facilities. All of these are classified as direct capital costs (Fathi, 2017: 72). Direct capital costs therefore comprise the expenditures incurred and paid by the contractor under the exploration activity plan, the delineation operations plan, the development and production operations plan, and all other approved work programs and budgets essential to achieving the contract objectives. These expenditures are reflected in the annual

work and budget plan, which must be approved by the Joint Development Committee and the National Iranian Oil Company, and serve as the basis for the approval and reimbursement of direct capital costs. Notably, unlike in Buy Back contracts, this portion of direct capital costs does not have a predetermined ceiling and is instead determined annually based on reservoir performance and market conditions (assumptions).

Capital costs include both direct costs and project management costs, the latter of which may not exceed ten percent of the direct cost amount (Shiravi, 2021: 442). Generally, these costs are categorized into two groups: tangible capital costs and intangible capital costs. Intangible capital costs include activities such as seismic surveys, while tangible capital costs cover items such as field facilities and installed equipment. Typically, intangible costs are expensed as incurred, whereas tangible capital costs are depreciated over time (Kasriel & Wood, 2013: 34–35).

According to Clause "R" of Article One of the General Terms, Structure, and Model of Upstream Oil and Gas Contracts, capital costs include "all capital expenditures necessary for the development, improvement, or increase of the reservoir's recovery factor, including all management, engineering, and drilling expenses; the construction of all necessary surface and subsurface facilities required to render the field or reservoir operational, such as processing facilities, transportation, injection, auxiliary, and process installations, and the commissioning of all units; expenditures incurred during the exploration phase if the field is commercially viable; and the execution of repairs, reconstructions, and necessary modernizations in fields or reservoirs under production."

With respect to the reimbursement of direct costs, the cost ceiling is one of the most important regulatory mechanisms. In Buy Back contracts, a reimbursement ceiling is established to prevent excessive contractor spending and to safeguard petroleum expenditures; thus, increases in costs due to price escalation or changes in the scope of work do not automatically result in a higher ceiling, although exceptions may be granted under special conditions, such as expanded project objectives (Shiravi, 2021: 445). In 2007, with the approval of the general framework for Buy Back contracts and the introduction of the third generation of these agreements, determination of the ceiling was deferred until after the completion of FEED studies and subsidiary contract tenders.

In contrast, IPC contracts remove the cost ceiling entirely, due to the difficulty contractors face in setting such a ceiling based on operational data and the long-term nature of these agreements. As a result, the annual work and budget plan serves as the principal mechanism for cost control. Each year, based on an evaluation of the results from the previous phase's development activities and reservoir performance, the development plan for the subsequent phase is revised and amended, and the parties reach agreement on the updated plan. A deviation of up to five percent from the approved annual budget is permitted (Hatami and Karimiyan, 2014: 715).

2.2. Categories of non-capital or indirect costs

Non-capital costs refer to expenses that are indirectly, yet necessarily, incurred and paid by the contractor in order to execute development operations (Ebrahimi and Ghasemi Moghadam, 2014: 35). Indirect costs in IPC and Buy Back contracts are largely identical. Non-capital or indirect costs include all expenditures incurred by the contractor in connection with oil field operations that are payable to Iranian governmental bodies and authorities. These expenditures include corporate income tax, value-added tax, withholding tax deducted from monthly salaries, social security contributions, customs duties and tariffs, and any other government-mandated fees, wages, and statutory charges, excluding any

penalty, cost, or fine arising from the contractor's fault. All such expenses are collected by the Iranian government, its agencies, and its officials in accordance with applicable law. In addition to these items, any cost that could not be precisely determined at the time of contract conclusion and is designated in the contract as a non-capital cost is also included. These expenses further encompass employee training programs and the provision of training courses. They typically account for approximately 10 to 15 percent of non-capital costs, are subject to no ceiling, and are fully reimbursable.

Indirect costs in petroleum contracts therefore include all expenses that have been incurred, committed, and paid by the contractor indirectly in relation to development operations. During the reimbursement period, and in accordance with the relevant contractual mechanisms, these costs are depreciated. Consequently, all taxes paid—without any ceiling—are reimbursable to the contractor, and all withholding taxes that the employer is required to deduct are paid from the oil company's resources directly to the Tax Affairs Organization (Hatami and Karimiyan, 2014: 714).

According to Clause "Z" of Article One of the General Conditions, Structure, and Model of Upstream Oil and Gas Contracts approved by the Cabinet, indirect costs are defined as "expenses that are incurred and paid by the contractor indirectly, yet necessarily, for the purpose of executing development operations."

2.3. Operating or exploitation costs

Operating costs are expenses incurred by the contractor in connection with oil operations, in accordance with the development and production plan and the annual work and budget plan approved by the employer. These costs are charged to the project only when the contractor is responsible for field operations. In Buy Back contracts, since production is limited, such costs apply primarily to the early production phase, during which the contractor, in addition to continuing development operations, also undertakes the operation of early production wells and facilities, or during a period when the project has reached its final production stage but has not yet been delivered to the employer. In contrast, under IPC contracts, as the contractor retains operational responsibility throughout the contract, operating costs assume greater significance over the contract term. Based on their method of calculation, operating costs are divided into two categories: fixed operating costs and variable operating costs. In IPC contracts, if the field has no production history, operating costs commence once production is achieved under the contract; however, if the field is already producing at the time of contract execution, operating costs are considered from the moment the contractor undertakes operational activities. Operating costs are uncapped and fully reimbursable, subject to audit. These expenses are calculated based on actual costs, monitored by the National Iranian Oil Company through the annual work and budget plan and auditing. According to Clause "Z" of Article One of the General Conditions, Structure, and Model of Upstream Oil and Gas Contracts approved by the Cabinet, "all amounts that the second party expends under the contract for carrying out exploitation operations and based on the conditions stipulated in the contract and accounting standards" are considered operating costs.

3. Accounting and auditing procedures of Iran's upstream oil contracts

The categorization of the aforementioned costs requires careful and meticulous review by both the contractor and the employer. Precise classification of costs associated with these contracts is of paramount importance. This categorization must ensure that expenses related to exploration, development, production, transportation, and oil sales are accurately measured and clearly reflect the proportion attributable to each activity. In accounting procedures, the accurate determination and

allocation of costs are especially critical, as they not only facilitate correct reporting of financial results but also serve as a primary tool for evaluating the financial and operational performance of the contracts. Attention to detail and a thorough review of cost categorization are therefore essential, as they underpin precise decision-making and the comprehensive assessment of oil contracts' financial and operational outcomes. In the final section, the accounting procedures of Iran's upstream oil contracts will be examined across four chapters.

3.1. Contractor obligations regarding project auditing and other accounts, documents, and reports

As the operating oil company, the contractor is obligated to perform specific duties regarding the expenses it incurs. One such duty concerns the preparation of project accounts. The contractor must maintain accounts that accurately record costs and credits arising from project operations. Auditing of these costs must comply with international financial reporting standards and be reflected in the cost and credit accounts. Project auditing is generally conducted on two bases: accrual auditing and cash auditing. In cash-based accounting, revenues and expenses are recorded when cash is actually paid or received. In contrast, accrual-based accounting records revenue when it is earned—that is, when goods or services are delivered, regardless of cash receipt—and records expenses when obligations are incurred, not when cash is disbursed. Consequently, accrual auditing provides a clearer and more accurate representation of the company's performance over the auditing period (Gnanarajah, 2014:21). Accordingly, the contractor is required to maintain accounts on an accrual basis, even though expense reimbursement is executed on a cash-auditing basis.

Furthermore, the contractor is responsible for designing the chart of accounts. This chart must outline the proposed overall layout of accounts, operational records, reports, and invoices, and be submitted in writing to the employer within 30 days from the date the contract becomes enforceable, in accordance with international financial reporting standards. The contractor and employer must agree on the chart of accounts, records, reports, and accounting statements—which define the system's foundations and accounting procedures—within 90 days from the contract's effective date. Following such agreement, the contractor must prepare and deliver the finalized chart to the employer within seven days. The comprehensive accounting chart must be submitted to the employer within 120 days, and the employer is required to notify the contractor of its approval or rejection within the same period; failure to do so shall constitute deemed acceptance.

Regarding books and archives, the contractor must accurately and meticulously prepare, maintain, and safeguard all records, documents, and supporting materials, reflecting actual costs incurred or paid in connection with oil operations. These materials include invoices, accounting books, inventory records, wages, salaries, and any other relevant documentation associated with costs and credits under the contract. The contractor is also required to submit the accounting manual to the employer. Additionally, legal audit books must be prepared in Persian and designed in accordance with applicable legal requirements.

3.2. Reimbursable and payable oil costs

Costs incurred for oil operations, in accordance with the approved annual work and budget plan or as determined by the Joint Operations Committee and ratified by the employer, and executed based on the development, production, and operation plan, shall be reimbursable. Reimbursement of these costs is conditional upon two requirements: first, that the finalized expenses are accurately and correctly recorded in the project accounts, without duplication, in accordance with the designated classifications and any subordinate categories; and second, that the reimbursement of expenses and wages is properly

and precisely reflected in the quarterly statements. Except for indirect costs explicitly defined in the contract, the allocation of oil costs between direct capital costs and operating costs shall follow international financial reporting standards. None of these accounting procedures shall be interpreted in a manner that releases the contractor from its obligation to obtain the necessary approvals from the employer. Accordingly, all oil costs to be reimbursed by the employer—including operating costs and indirect costs—shall be clearly specified and scheduled for reimbursement within the prescribed timeframe.

3.3. Reimbursement of oil costs, payment of financial or money costs, fees, and related invoices

For the reimbursement of costs and accrued interest, as well as the payment of wages, the contractor is required to submit a financial report to the employer every month, no later than the 20th day of the following month, in the agreed-upon format. This financial report shall detail the expenses and credits related to oil operations, providing an appropriate description of accounts and sub-accounts, including their classification, nature, source, date, and any incidents associated with the incurred costs. The report must also reference the corresponding annual work and budget plan and the approved budget from the beginning of the year to the reporting date, based on both accrual and cash accounting, on a monthly, quarterly, and annual basis.

Reimbursement of costs and payment of the contractor's fees is contingent upon the submission of a quarterly invoice for cost reimbursement and fees. The contractor, beginning from the quarter in which operational transfer occurs, must submit this invoice to the employer. The Joint Operations Committee shall review the submitted invoice within ten working days of receipt and, if necessary, provide recommendations. The contractor is then required to implement any necessary amendments within five days and resubmit the invoice to the Committee. Once the invoice is forwarded to the employer, the employer must notify the contractor in writing of any discrepancies or expectations within an additional five working days; failure to do so within this timeframe shall constitute acceptance. The invoice must include information on the classification of the aforementioned costs, covering past periods, the current month, and the forthcoming quarter.

The amount payable to the contractor for reimbursement of costs and payment of wages shall be recorded in the project accounts. Regarding payment terms, cash payments shall be made within 30 days from the end of the quarter for which the quarterly reimbursement and wage invoice has been submitted, whereas non-cash payments shall be based on the bill of lading date of the long-term crude oil sales agreement.

4. Accounting and auditing procedures for oil contracts in the transnational oil and gas industry

As stated, the Cabinet Resolution concerning the general conditions, structure, and model of oil contracts has established a modernized framework for Iran's oil contracts. Under Article 4 of this resolution, the second party in IPC contracts is categorized into two main groups: first, the participation of Iranian and foreign companies under the leadership of an Iranian company; and second, the participation of foreign and Iranian companies under the leadership of a foreign company. Additionally, Cabinet Resolution No. 104089/T 52445 provides for contract execution through the establishment of a joint operating company or a joint operating agreement, with responsibility vested in this legal entity (Kazemi Najafabadi & Hashemi, 2019:441). Although this clause was subsequently removed in later amendments, Section "A" of Article 11 allows the first party, if necessary and with the approval of the Ministry of Oil, to enter into a joint operating agreement between the second party of the contract and

the oil company's subsidiaries, thereby enabling exploitation operations while maintaining the contractor's responsibility.

Consequently, in Iran's new oil contracts, the formation of joint investments and joint operating agreements is critical, given the essential technology transfer required to enhance production efficiency and ensure domestic energy security. These joint operating contracts are not only a focal point in Iran but also in international oil associations worldwide. The purpose of this approach is twofold: first, to establish an operational framework through which costs and revenues associated with activities specified in the joint operating agreement are allocated between the parties; and second, to ensure that expenses legitimately incurred by the operating company as a result of these activities are reimbursed by the parties.

Accordingly, the aim of this section is to advance the development of accounting and auditing procedures for domestic oil contracts in which operational activities are assigned to an Iranian subsidiary company through a joint operating agreement, by conducting a comparative review of sample accounting and auditing procedures published by international private organizations and addressing specific issues inherent in joint operating contracts.

4.1. Principles governing global accounting procedures

In general, the primary purpose of accounting procedures is to outline the steps undertaken by the operating company when allocating joint operations and reporting incurred costs to the non-operating companies. These procedures should be prepared in a clear and straightforward manner. However, through critical analysis and in-depth study, accountants and auditors can gain a more comprehensive understanding of the rules and procedures involved, as well as the relationships between the rights and responsibilities of operating and non-operating companies. Readers of this document should also be aware of the strategic interests of both parties, understand common types of contracts, the main types of trade, and the key characteristics of the oil industry (Eduardo et al., 2016:7).

The oil industry is characterized by complex operations that place substantial investments at risk and require significant financial resources. In this context, multiple variables must be considered, including geopolitical, technical, political, and commercial risks, as well as the national and international interests of stakeholders and price fluctuations.

First, the operating company must maintain a designated joint account through which currency fluctuations and the inflows and outflows related to joint operations are recorded, providing periodic account statements (and other relevant data) to the non-operating parties. The joint account is typically maintained in a single currency, with a protocol established for determining the applicable exchange rate for other currencies. It is also possible for parties to agree on a multi-currency joint account, and preferential conditions related to the host country's currency operations may necessitate this arrangement.

The joint operating agreement (accounting procedure) depends on the operator's ability to combine its own funds with those of the non-operating parties in the joint account, as well as on whether the joint account is treated as a long-term deposit account (Roberts, 2012:212). The operator's ability to combine these funds through a non-segregated bank account often raises concerns. The operating company views this as a straightforward procedural measure that facilitates performance of its duties without appropriating the funds of other parties. Conversely, non-operating parties are generally concerned that, in the event of the operator's bankruptcy, such funds may be transferred to a liquidator and potentially lost. As a result, the joint operating agreement may permit, prohibit, or initially allow the combination of funds with the right for parties to request segregation later.

Several fundamental principles commonly guide accounting procedures. These include the principle of fair operation, which ensures that costs and revenues are equitably allocated among parties, and the "no profit, no loss" principle, under which the operator should neither gain nor lose as a result of performing its duties. Additional guiding principles include systematic consistency, allowance for adjustments, and governance provisions in the joint operating agreement to resolve conflicts, all of which are essential for the formulation and implementation of accounting procedures.

4.2. Scope of the parties' auditing rights

The operator may prefer to prohibit, or at least restrict, any party's ability to exercise auditing rights over entities affiliated with the operator that participate in the execution of joint operations, as such entities are often engaged in business activities beyond the scope of the joint operating agreement. A potential compromise is for the auditing of such entities by one party to be conducted either by the operating company's legal auditor or by an independent third-party auditor, with the scope of the investigation limited to issues specifically related to the joint operating agreement. A similar concern arises in cases where the operating company has entered into government contracts for the execution of joint operations.

4.3. Reimbursement of direct and indirect costs

In cases where costs incurred by the operating company relate to contracts with its affiliated companies, related entities, or government contracts, the parties are keen to ensure that these costs align with market rates and do not include any additional or unwarranted amounts for the affiliated company, related entity, or governmental contractor.

Parties may also be reluctant to bear a share of the operating company's general overhead costs, as doing so could effectively subsidize only the operating company's current expenses and, in some cases, indirectly subsidize other projects in which the operating company is involved, while non-capital costs in those projects are either not incurred or are applied to a lesser extent. In such contexts, the optimal approach for one party is to negotiate a reduction in the non-capital costs payable to the operating company, minimizing them to the lowest feasible level. Auditing rights regarding these costs are typically limited to verifying that the overhead percentage calculations have been correctly applied and generally do not extend to evaluating the detailed actual overhead costs or their reasonableness.

5. Conclusions

As observed, within Iran's oil contract framework, costs arising from petroleum operations are categorized into distinct groups and reimbursed to the contractor through a contractual annex in accordance with a defined accounting and auditing procedure, ensuring order and coherence in expense reimbursement.

However, in recent years, Joint Operating Agreements (JOAs) have gained increasing significance within Iran's legal framework to facilitate technology transfer in production and operations and to enhance the recovery factor of hydrocarbon fields. Many current accounting procedures, however, fall short of addressing the complexities inherent in the operator–non-operator relationship under JOAs. Alongside this, model JOA contracts developed by international petroleum associations include corresponding accounting procedures that incorporate the specific intricacies of such contractual arrangements. For example, these procedures address issues such as the establishment of a joint account to record foreign currency movements and fund inflows and outflows related to joint operations, determining whether fund pooling by the operator is permissible, limiting or restricting the non-operator's ability to exercise audit rights, and specifying mechanisms whereby audit rights over entities

affiliated with the operator are exercised by either the operator's legal auditor or a mutually agreed independent third-party auditor, limited strictly to issues related to joint operations.

Consequently, attention to these technical details and nuances in the design of accounting procedures for such contracts must be explicitly incorporated into Iran's oil contracts. Doing so is essential to prevent overhead cost disputes, mitigate potential auditing conflicts, and ensure the financial transparency required for the optimal exploitation of the country's oil resources.

Nomenclature

FEED	Front-end engineering and design
IPC	Iranian Petroleum Contract
JOA	Joint Operating Agreements

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