

FASB Emerging Issues Task Force

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Title: Accounting for Suspended Well Costs

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References:

FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies* (FAS 19)

FASB Statement No. 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies* (FAS 25)

FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities* (FAS 69)

*** The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination and it is ratified by the Board.**

Background

1. Paragraph 19 of FAS 19 requires costs of drilling exploratory wells to be capitalized pending determination of whether the well has found proved reserves. If the well has proved reserves, the capitalized costs become part of the entity's wells, equipment, and facilities; if, however, the well has not found proved reserves, the capitalized costs of drilling the well are expensed, net of any salvage value. Questions have arisen in practice about the application of this guidance due to changes in oil- and gas-exploration processes and lifecycles.

Changes in oil and gas exploration

2. Significant changes in oil and gas exploration have occurred since the FASB issued FAS 19 in 1977. Exploration activities are now frequently performed in more remote areas, to greater depths, and in more complex geological formations. The following list highlights some of the factors that oil- and gas-producing entities now routinely encounter during the exploration process that were not as prominent when FAS 19 was issued:

- The depleting nature of oil and gas reserves has necessitated expanding exploration activities beyond North America and the Middle East to countries around the world. Country "border issues" require more negotiations among countries, regional jurisdictions, and sometimes tribal councils than required in 1977. This may occur when multiple jurisdictions jointly own (or dispute ownership) of mineral interests or when a single jurisdiction owns mineral rights, but the transportation of the oil and gas must cross into other jurisdictions.
- The scale and cost of most current exploration and development projects, particularly international projects, require joint venture arrangements and/or third-party financing. Accordingly, plans for project development often are well advanced before successful exploratory wells can result in proved reserves being recognized.
- International natural gas projects in remote, offshore areas require more time to obtain customer sales agreements and develop plans for constructing liquefying, transporting, and regasifying facilities.
- Environmental concerns involve greater investments of time and money before a project can advance.

- Technological advances in recent years have enabled the discovery and production of hydrocarbons from greater depths, especially offshore. However, additional time is often required to establish the economic viability of such projects.
- Development of discoveries in areas with existing infrastructure is often dependent on future pipeline capacity.
- Governments are more involved in the project-approval process in both developed and developing countries and certain governments are requiring public/private partnerships to develop the reserves.

These changes in the business model have resulted in an increased frequency of exploratory wells that successfully find reserves that cannot be recognized as *proved* when drilling is completed. An important aspect of understanding why those situations occur is to understand the information and factors required to classify reserves as *proved*.

Proved Reserves

3. In certain circumstances, an exploratory well can find reserves but classification of those reserves as proved cannot be made when drilling is completed. For example, after reserves are found, an entity may be required to obtain additional geological information, government approvals, sales contracts through negotiations, and project financing before the entity can classify the reserves as proved—of which, any of these factors could preclude the entity from classifying the reserves as proved. This section briefly addresses proved reserves.

4. Appendix B of FAS 25 includes the definition of proved reserves. The following is an excerpt.

Proved oil and gas reserves. Proved oil and gas reserves are the estimated quantities of crude oil, natural gas, and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under *existing economic and operating conditions*, i.e., prices and costs as of the date the estimate is made. Prices include consideration of changes in existing prices provided only by contractual arrangements, but not on escalations based upon future conditions. [Emphasis added.]

To meet the classification of proved reserves, the geological and engineering data must support with reasonable certainty that the quantities of reserves are recoverable under *existing economic and operating conditions* (typically, prices and costs at the date that the estimate is made).

5. The SEC staff has provided SEC registrants with guidance to assist them in their determination of whether reserves meet the definition of proved reserves including guidance that specifically addresses *existing economic and operating conditions*.¹ That guidance includes the following:

...those conditions include product prices, operating costs, production methods, recovery techniques, transportation and marketing arrangements, ownership and/or entitlement terms and regulatory requirements that are extant on the effective date of the estimate. An anticipated change in conditions must have reasonable certainty of occurrence; the corresponding investment and operating expense to make that change must be included in the economic feasibility at the appropriate time.

This SEC staff guidance also provides guidance on developing oil and gas areas:

In developing frontier areas, the existence of wells with a formation test or limited production may not be enough to classify those estimated hydrocarbon volumes as proved reserves. Issuers must demonstrate that there is reasonable certainty that a market exists for the hydrocarbons and that an economic method of extracting, treating and transporting them to market exists or is feasible and is likely to exist in the near future. A commitment by the company to develop the necessary production, treatment and transportation infrastructure is essential to the attribution of proved undeveloped reserves. Significant lack of progress on the development of such reserves may be evidence of a lack of such commitment. Affirmation of this commitment may take the form of signed sales contracts for the products; request for proposals to build facilities; signed acceptance of bid proposals; memos of understanding between the appropriate organizations and governments; firm plans and timetables established; approved authorization for expenditures to build facilities; approved loan documents to finance the required infrastructure; initiation of construction of facilities; approved environmental permits etc. Reasonable certainty of procurement of project financing by the company is a requirement for the attribution of proved reserves. An inordinately long delay in the schedule of development may introduce doubt sufficient to preclude the attribution of proved reserves.

¹ SEC's Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance (March 31, 2001).

The history of issuance and continued recognition of permits, concessions and commerciality agreements by regulatory bodies and governments should be considered when determining whether hydrocarbon accumulations can be classified as proved reserves. Automatic renewal of such agreements cannot be expected if the regulatory body has the authority to end the agreement unless there is a long and clear track record which supports the conclusion that such approvals and renewal are a matter of course.

Clearly, the determination of whether reserves can be classified as proved reserves is a complex matter in which an entity carefully must consider both geological and economic factors.

Accounting for exploratory well costs

6. Under FAS 19, an entity capitalizes exploratory well costs pending determination of whether the well has found proved reserves. If the well has proved reserves, the entity continues to carry the costs of the well as an asset; if, however, the well has not found proved reserves, the entity expenses any capitalized costs, net of any salvage value. FAS 19 acknowledges that an exploratory well may find reserves, but classification of those reserves as proved cannot be made when drilling is completed. Paragraphs 31-34 of FAS 19 provide guidance on whether exploratory well costs can continue to be capitalized in those situations.

7. If classification of proved reserves cannot be made at the completion of the drilling in an area requiring a major capital expenditure, paragraph 31(a) requires that the cost continue to be carried as an asset provided that; (a) there have been sufficient reserves found to justify completion as a producing well if the required capital expenditure is made and (b) drilling of the additional exploratory well is underway or firmly planned for the near future. If either of those two criteria is not met, the entity must expense the exploratory well costs.

8. For all other exploratory wells not addressed in paragraph 31(a), paragraph 31(b) requires the capitalized costs to be charged to expense if the reserves cannot be classified as proved after a year following the completion of drilling.

9. Paragraph 32 clarifies that deferral is not appropriate merely on the chance that some event totally beyond the control of the entity occurs that would result in the reserves being classified as

proved—for example, the price of oil and gas increases to a point that development becomes economically viable.

Accounting Issue and Alternatives

10. Application of paragraph 31 of FAS 19 to the facts and circumstances commonly faced by oil- and gas-producing companies in the current exploration environment has become a concern. There are diverse views on how an entity should evaluate the paragraph 31 criteria in this changed environment—specifically, the one-year deferral period.

Issue: Whether there are circumstances that would permit the continued capitalization of exploratory well costs beyond one-year other than when additional exploration wells are necessary to justify major capital expenditures and those wells are underway or firmly planned for the near future.

View A: No. There are no circumstances that would permit continued capitalization of exploratory well costs beyond one-year other than when additional exploratory wells are necessary to justify a major capital expenditure and those wells are underway or firmly planned for the near future.

11. Proponents of View A believe that paragraph 31 of FAS 19 is clear that the only exploratory well costs that can be deferred beyond one year are those costs that are incurred under circumstances in which additional exploratory wells are necessary to justify major capital expenditures and those wells are underway or firmly planned for the near future. That is, paragraph 31(a) only applies to situations in which additional exploratory wells are necessary to determine whether major capital expenditures are economical. All other situations are subject to subparagraph 31(b) and its one-year limitation on the deferral of exploratory well costs.

12. Under View A, if no additional exploratory drilling is under way or firmly planned to occur in the near future to justify major capital expenditures, an entity must classify reserves as proved reserves within one year following the completion of the exploratory well to avoid charging the cost of the exploratory well to expense. That is, the continued capitalization of exploratory well

costs beyond one year following the completion of drilling is dependent on the need to drill additional exploratory well costs to justify major capital expenditures. View A proponents support their view based the second sentence of subparagraph 31(a), which states, "On completion of drilling, an exploratory well may be determined to have found oil and gas reserves, but classification of those reserves as proved depends on whether a major capital expenditure can be justified which, in turn, *depends on whether additional exploratory wells find a sufficient quantity of additional reserves*" (emphasis added).

13. View A opponents believe that View A does not recognize the changes that have occurred in the exploration process since the issuance of FAS 19. Accordingly, they believe that View A results in accounting that is inconsistent with the fundamental premise of successful efforts accounting under FAS 19. That is, the capitalization of successful exploratory wells should not be dependent on whether additional exploratory wells are necessary or limited to when proved reserves can be established during a one-year period.

View B: Yes. If an exploratory well has found reserves and additional exploratory wells are not necessary to justify a major capital expenditure, the associated exploratory well costs may be capitalized for as long as (a) the well has found a sufficient quantity of reserves to justify its completion as a producing well assuming that the required capital expenditures are made and (b) the entity is making sufficient progress assessing the reserves and the economic and operating viability of the project.

14. View B proponents believe that exploratory well costs can be capitalized beyond one year pending the determination of whether the reserves are proved if (a) the well has found a sufficient quantity of reserves to justify its completion as a producing well assuming that the required capital expenditures are made and (b) the entity is making sufficient progress assessing the reserves and the economic and operating viability of the project.

15. All relevant facts and circumstances should be evaluated when determining whether an entity is making sufficient progress on assessing the reserves and the economic and operating

viability project. The following are some indicators, among others, that an entity is making sufficient progress:

- Commitment of personnel to the project with the appropriate level and skills
- Costs are being incurred to assess the reserves and the potential development
- An assessment process covering the economic, legal, political, and environmental aspects of the potential development is in progress
- Existence (or active negotiations) of sales contracts with customers for the oil and gas
- Existence (or active negotiations) of memos of understanding and agreements with governments, lenders, and venture partners
- Outstanding requests for proposals for development of the required facilities
- Existence of firm plans and established timetables.

While these are indicators that an entity is making progress toward assessing the reserves and the project, long delays in the assessment or development plan (whether anticipated or unexpected) raises doubts about whether the entity is making sufficient progress to continue the capitalization of exploratory well costs after one year following the completion of drilling. If an entity has not engaged in substantial activities, or activities have been suspended, to assess the reserves or the project one year following the drilling of the exploratory well is completed, any capitalized costs associated with that well should be expensed, net of any salvage value. Activities that are firmly planned for the near future (other than additional exploration wells under paragraph 31(a)) do not represent sufficient progress in assessing the reserves or the project to continue the capitalization of exploratory well costs beyond one year from when the drilling of the exploratory well is completed. An entity should expense any capitalized exploratory well costs when it no longer plans to continue the assessment of the reserves and the economic and operating viability of the project. However, brief interruptions in the activities required to assess the reserves or the project should not require capitalized costs to be expensed.

16. Consistent with paragraph 32 of FAS 19, View B proponents do not believe that an entity should defer costs merely on the chance that some event will occur that is totally outside of its control.

17. View B proponents believe that View B is consistent with the fundamental premise of the successful efforts method of accounting under FAS 19—that is, the costs of exploratory wells should be capitalized until an entity can determine whether the well has found proved reserves. View B provides an opportunity to defer exploratory well costs beyond the one-year if the entity is actively pursuing an evaluation of the reserves and the economic and operating viability project. View B supporters believe that this principle is consistent with the Board's basis for conclusions in paragraphs 198 and 199 of FAS 19.

18. View B proponents believe that it is reasonable to expect that the evaluation of whether reserves are proved may take longer than a one-year period in the current oil- and gas-exploration lifecycle. They note that paragraph 199 of FAS 19 acknowledges that evaluation can take longer than a matter of weeks or months and they believe that the Board intended the one-year limit to accommodate the typical assessment period that existed in 1977 for an exploration well that had found reserves. Accordingly, proponents believe that View B, which permits the continued capitalization of successful exploratory well costs with some limitations, is consistent with the Board's objectives of permitting exploratory well costs to be carried during the assessment period and the principles underlying the successful efforts method of accounting.

19. Further, View B proponents believe that the term "rarely longer" in paragraph 199 is evidence that the Board was deliberating the accounting for exploratory costs in an environment and business model that is much different from today's. Longer assessment periods for the reserves are much more common. In fact, some assert that a majority of exploratory wells require more than a year to assess and they believe that this longer decision-making process should not result in a fundamental change in the successful efforts method of accounting. That is, limiting the assessment period to one year effectively will require many entities to expense the majority of their exploratory well costs, including those costs associated with wells that eventually become productive.

20. View B opponents believe that View B is inconsistent with paragraphs 31 and 32 of FAS 19 (and, potentially, might result in an amendment to FAS 19). Additionally, opponents believe that

View B provides too much discretion for when exploratory well costs can be carried as an asset and, accordingly, it will result in non-comparability between similar entities.

Examples

21. Example 1 addresses the application of the guidance in paragraph 31(a) of FAS 19 to illustrate the interaction of the existing guidance with this Issue. Example 2 illustrates the application of Views A and B.

Example 1

Oil Company has an offshore concession from the Country of X. Oil Company drills a single exploratory well that finds producible quantities of oil reserves. It is unclear whether sufficient reserves exist to justify building a production platform and trunk pipeline (a major capital expenditure). Accordingly, the reserves are not classified as proved. Oil Company has firm plans to drill a second exploratory well in the near future in order to get additional information to determine whether the reserve quantities are sufficient to justify the major capital expenditure.

In accordance with paragraph 31(a) of FAS 19, Oil Company should capitalize the costs of the first exploratory well pending the results of the second exploratory well.

Example 2

Consider the same facts as Example 1; however, Oil Company drills a second exploratory well and finds additional crude oil reserves in multiple zones. Oil Company now has the option of developing a single zone or multiple zones. If the company develops a single zone, a small pipeline will be built to an existing facility. If the company develops multiple zones, a floating oil storage facility will be required. The company actively is assessing whether the reserves are proved and comparing the economic and regulatory aspects of the multiple zone option versus the single zone option. The analysis will take over a year. Until the analysis is complete, the company is unable to classify the reserves as proved.

Under View A, the company should expense the costs associated with the exploratory wells. The evaluation of whether the reserves can be classified as proved does not depend on the drilling of additional exploratory wells to find quantities of reserves to support a major capital expenditure. Accordingly, the company should evaluate the capitalization of the exploratory well costs under paragraph 31(b) of FAS 19, not paragraph 31(a). Paragraph 31(b) provides a one-year time limit on the capitalization of exploratory well costs after the drilling of the well is completed. In this example, the determination of whether the reserves are proved will not be completed during the one-year time period and, accordingly, the exploratory well costs should be expensed.

Under View B, the company should continue to capitalize the exploratory well costs for as long as it is making sufficient progress on assessing whether the reserves are proved and whether to pursue the development of the project. The determination of whether sufficient progress is being made should be based on all the relevant facts and circumstances (see proposed indicators). In this example, the company is actively assessing the project, and if the company is making sufficient progress, it should continue to capitalize the exploratory well costs.

Transition

22. The FASB staff believes that a consensus on this Issue should be applied to existing and prospective capitalized exploratory well costs. Additionally, the staff believes that the consensus should be applied to the first reporting period beginning after Board ratification of this consensus. If the Task Force reaches a consensus at the September 29–30, 2004 EITF meeting, the consensus would be considered by the Board for ratification at the October 13, 2004 Board meeting. The staff also recommends that:

- Any capitalized exploratory well costs that are expensed upon the application of this consensus should be recognized as a component of income from continuing operations
- Capitalization of exploratory well costs previously expensed should not be permitted
- Early application of this guidance should be permitted in periods for which financial statements have not yet been issued.

Disclosures

23. FAS 69 requires disclosure of capitalized costs; however, an entity is not required to disclose how long exploratory well costs have been capitalized and the entity may combine exploratory wells costs with other types of capitalized costs (for example, unproved properties). If a View B consensus is reached, the Task Force should consider whether an entity should provide additional disclosures about exploratory well costs that have been capitalized pending the determination of whether the reserves are proved. For example, the Task Force could require an entity to disclose the amount of exploratory well costs that have been carried as an asset for a period longer than one year since the completion of drilling of the exploratory well. The Task Force could also require an entity to provide qualitative disclosures regarding those amounts—such as, a description of the circumstances required to classify the reserves as proved and the expectation about the timing of when the reserve evaluation will be completed.