FASB Interpretation No. 33

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Applying FASB Statement No. 34 to Oil and Gas Producing Operations Accounted for by the Full Cost Method

an interpretation of FASB Statement No. 34

August 1980

Financial Accounting Standards Board
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FASB Statement No. 34, *Capitalization of Interest Cost*, establishes standards for capitalizing interest cost as part of the historical cost of acquiring certain assets. This Interpretation clarifies that the assets of an oil and gas producing operation accounted for by the full cost method that qualify for capitalization of interest are:

a. Those unusually significant investments in unproved properties and major development projects that are not being depreciated, depleted, or amortized currently and
b. Significant properties and projects in cost centers with no production,

provided that exploration or development activities on such assets are in progress.

INTRODUCTION

1. The FASB received several inquiries from oil and gas producing enterprises that use the full cost method of accounting asking how they should apply FASB Statement No. 34, *Capitalization of Interest Cost*, to their operations. Appendix A contains background information about those inquiries.

INTERPRETATION

2. For purposes of applying Statement 34 to oil and gas producing operations accounted for by the full cost method, assets whose costs are being currently depreciated, depleted, or amortized are assets in use in the earning activities of the enterprise and are not assets qualifying

for capitalization of interest cost as defined in paragraph 9 of Statement 34. Unusually significant investments in unproved properties and major development projects that are not being currently depreciated, depleted, or amortized and on which exploration or development activities are in progress are assets qualifying for capitalization of interest cost. Similarly, in a cost center with no production, significant properties and projects on which exploration or development activities are in progress are assets qualifying for capitalization of interest cost.

EFFECTIVE DATE AND TRANSITION

3. The provisions of this Interpretation shall be effective for annual financial statements for fiscal years beginning after December 15, 1979 and for interim periods within those fiscal years, with earlier application encouraged. Enterprises that have applied Statement 34 in a manner contrary to this Interpretation in previously issued annual financial statements are encouraged, but are not required, to restate those financial statements and financial information for interim periods within those fiscal years to give effect to the provisions of this Interpretation. If those annual financial statements are not restated, the effect that the provisions of this Interpretation would have had in those financial statements shall be disclosed in the annual financial statements in which this Interpretation is first applied. Likewise, the effect that this Interpretation would have had on the financial information for interim periods within those years shall be disclosed whenever financial information for those interim periods is presented.

4. If the change to conform to the provisions of this Interpretation is made in *other than* the first interim period of an enterprise's fiscal year, financial information for the prechange interim periods of that fiscal year shall be restated by applying the newly adopted method of applying Statement 34 to those prechange interim periods. Whenever financial information that includes those prechange interim periods is presented, it shall be presented on the restated basis. In addition, the following disclosures shall be made for the interim period in which the provisions of this Interpretation are adopted:

a. The nature of the change in method of applying Statement 34;
b. The effect of the change on income from continuing operations, net income, and related per share amounts for each prechange interim period of that fiscal year; and
c. Income from continuing operations, net income, and related per share amounts for each prechange interim period restated in accordance with this Interpretation.

Appendix A: BACKGROUND INFORMATION

5. Paragraph 9 of Statement 34 states that interest shall be capitalized on "assets that are constructed or otherwise produced for an enterprise's own use (including assets constructed or produced for the enterprise by others for which deposits or progress payments have been made)."

Such assets are referred to as "qualifying assets." Paragraph 10 of Statement 34, however, states that interest shall not be capitalized on:

> a. Assets that are in use or ready for their intended use in the earning activities of the enterprise
> b. Assets that are not being used in the earning activities of the enterprise and that are not undergoing the activities necessary to get them ready for use.

6. Appendix B of FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, discusses the full cost method. Paragraph 104 states that:

> Under the full cost concept, all costs incurred in acquiring, exploring, and developing properties within a relatively large geopolitical (as opposed to geological) cost center (such as a country) are capitalized when incurred and are amortized as mineral reserves in the cost center are produced, subject to a limitation that the capitalized costs not exceed the value of those reserves.

Paragraph 107 further states that:

> . . . acquisition, exploration, and development costs are sometimes included in the pool of capitalized costs associated with a cost center when incurred, so that if the cost center is producing, those costs are subject to amortization at once. In some cases, however, certain significant costs, such as those associated with offshore U.S. operations, are deferred separately without amortization until the specific property to which they relate is found to be either productive or nonproductive, at which time those deferred costs and any reserves attributable to the property are included in the computation of amortization in the cost center.

Proponents of the full cost method have traditionally argued that all exploratory and development costs should be capitalized because such costs represent the historical cost of an enterprise's proved oil and gas reserves. As stated in paragraph 102 of Statement 19:

> . . . all costs incurred in oil and gas producing activities are regarded as integral to the acquisition, discovery, and development of whatever reserves ultimately result from the efforts as a whole, and are thus associated with the company's reserves.

7. Securities and Exchange Commission (SEC) ASR No. 258, *Oil and Gas Producers—Full Cost Accounting Practices*, established "uniform requirements for financial accounting and reporting practices of oil and gas producers following the full cost method of accounting" and subject to SEC Rules. ASR 258 requires that costs to be amortized include "all capitalized costs, less accumulated amortization, other than the cost . . . of unusually significant investments in

unproved properties and major development projects," plus certain other costs.

8. A proposed Interpretation, *Applying FASB Statement No 34 to Oil and Gas Producing Operations Accounted for by the Full Cost Method*, was released for comment on January 28, 1980. The Board received 28 letters of comment to the proposed Interpretation. Certain of the comments received and the Board's consideration of them are discussed in paragraphs 9-15.

9. Two views have been expressed regarding what constitute the qualifying assets of an oil and gas producing operation accounted for by the full cost method. The first view is that major exploration or development projects constitute qualifying assets as long as exploration or development activities are in progress. Interest capitalization ends when those activities cease or when the property begins producing oil or gas, whichever comes first. Under this view, the qualifying assets of an oil and gas producing enterprise for purposes of capitalizing interest are the same regardless of whether the enterprise uses the successful efforts method or the full cost method.

10. Others argue that the first view fails to reflect the conceptual basis of the full cost method. Proponents of the full cost method have traditionally argued that the assets of an oil and gas producing company are not its individual properties, platforms, wells, and equipment, but are, rather, its underground oil and gas reserves. The historical acquisition cost of those reserves is the cumulative exploration and development expenditures of the enterprise and, accordingly, all exploration and development costs are capitalized. As reserves are produced, the costs of those reserves (the capitalized costs in the cost center) are amortized on a units-of-production basis. The cumulative capitalized costs in the cost center, therefore, represent the cost of one asset—proved oil and gas reserves—not an aggregation of the costs of separately identifiable assets each of which may or may not be ready for use. Once production begins, that asset is in use "in the earning activities of the enterprise" and is, therefore, not a qualifying asset for purposes of capitalizing interest. ASR 258 permits the costs of major nonproducing properties to be accounted for as separate assets excluded from the full cost pool and not amortized because the reserves related to those costs are not yet known. Nonproducing properties whose costs are excluded from the full cost pool and are not being currently amortized are not in use "in the earning activities of the enterprise."

11. The Board believes that the view expressed in paragraph 10 is consistent with the conceptual basis of the full cost method. By contrast, the view expressed in paragraph 9, that the assets of an oil or gas producer that qualify for capitalization of interest should be the same regardless of the accounting method used, creates conceptual implementation problems. Assume that an oil and gas producer drills three exploratory wells on a property, that the first two wells are dry holes, and that the third well locates proved reserves. If the enterprise uses the successful efforts method, it will charge the costs of the first two wells to expense when they are determined to be dry holes and cease to capitalize interest on them. Under the view expressed in paragraph 9, an enterprise that uses the full cost method would capitalize interest as a cost of the wells and would stop capitalization of interest on the first two wells when they are determined to

be dry holes. The full cost method, however, does not differentiate an exploratory dry hole from a successful exploratory well. All exploration costs are considered costs of locating proved reserves and the full cost method treats all exploration costs the same. Therefore, the arguments advanced in paragraph 9 would create a distinction between dry holes and successful wells that is incompatible with the full cost method.

12. Some respondents requested that the Board provide guidance to determine what constitute "unusually significant" investments and "major" projects. Those terms are taken from ASR 258, and enterprises subject to SEC rules have experience in applying those terms to their amortization policies. For enterprises not subject to SEC rules, the Board believes that judgments as to what constitute "unusually significant" investments and "major" projects should be determined by an enterprise and its auditors based upon the enterprise's facts and circumstances.

13. Some respondents suggested that the proposed Interpretation contradicted paragraph 18 of Statement 34, which states:

> The capitalization period shall end when the asset is substantially complete and ready for its intended use. Some assets are completed in parts, and each part is capable of being used independently while work is continuing on other parts. An example is a condominium. For such assets, interest capitalization shall stop on each part when it is substantially complete and ready for use. . . . Some assets cannot be used effectively until a separate facility has been completed. Examples are the oil wells drilled in Alaska before completion of the pipeline. For such assets, interest capitalization shall continue until the separate facility is substantially complete and ready for use.

Those respondents maintain that paragraph 18 of Statement 34 supports the view expressed in paragraph 9 of this appendix. Paragraph 18 of Statement 34, however, deals with the end of the capitalization period; it does not address what assets are qualifying assets. If an asset is not a qualifying asset for purposes of interest capitalization, then the duration of the capitalization period is not relevant.

14. The concept of assets completed in parts with each part capable of being used independently is compatible with this Interpretation. Interest may be capitalized as a part of the cost of unusually significant investments in unproved properties and major development projects that are not being currently depreciated, depleted, or amortized and on which exploration or development activities are in progress. Properties and projects whose costs are included in producing cost centers lose their separate identity, however, and are treated as part of a single, indivisible asset.

15. Some respondents found the effective date and transition provisions of the proposed Interpretation unclear. Other respondents objected to the requirement for enterprises that elected

early implementation of Statement 34 in a manner not compatible with the proposed Interpretation to restate their previously issued financial statements or financial information. The effective date and transition section has been revised to encourage, but not require, restatement.

This Interpretation was adopted by the affirmative votes of six members of the Financial Accounting Standards Board following submission to the members of the Financial Accounting Standards Advisory Council and the Screening Committee on Emerging Problems. Mr. Mosso dissented.

Mr. Mosso dissents because he believes this Interpretation misapplies (1) the basic premise stated in paragraph 6 of Statement 34 that the cost of acquiring an asset includes interest as part of "the costs necessarily incurred to bring it to the *condition and location* necessary for its intended use" and (2) that part of paragraph 18 which reads "Some assets are completed in parts. . . . interest capitalization shall stop *on each part* when it is substantially complete and ready for use" (emphasis added).

The Interpretation hinges on rejection of the applicability of paragraph 18 of Statement 34 which deals with the end of the capitalization period for assets that are partly ready for use and partly not. Rejection of paragraph 18 requires a determination that a producing cost center for oil and gas reserves represents a single, indivisible asset, wholly ready for use when it satisfies an accounting test, current amortization. That determination, however, ignores the fact that readiness for use is defined in paragraph 6 of Statement 34 essentially in terms of satisfying physical tests, condition and location, and the further fact that similar physical tests are implicit in the SEC rule for full cost accounting.

The SEC rule for amortizing a full cost pool reads in part: "Costs to be amortized shall include... the estimated future expenditures . . . to be incurred in developing proved reserves. . . ." The fact that estimated future development costs are required to be included in the current amortization charge is clear recognition that some portions of proved reserves may not be physically ready for current production even though other portions are currently producing. It is recognition that a proved but undeveloped oil and gas field constitutes an incomplete part of a larger asset complex, the full cost pool. Interest in that context is as much a future development cost as any other kind of capitalizable cost.

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