

FASB Interpretation No. 36

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Accounting for Exploratory Wells in Progress at the End of a Period

an interpretation of FASB Statement No. 19

October 1981



Financial Accounting Standards Board

of the Financial Accounting Foundation

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FIN 36: Accounting for Exploratory Wells in Progress at the End of a Period

an interpretation of FASB Statement No. 19

FIN 36 Summary

FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, requires that the costs of exploratory wells that do not locate proved oil and gas reserves (exploratory dry holes) be charged to expense. Questions have been raised about when to charge to expense the costs of an exploratory well in progress at the end of a period that is determined to be a dry hole before the financial statements for that period are issued. This Interpretation clarifies that the costs incurred through the end of the period shall be charged to expense for that period.

INTRODUCTION

1. The FASB has been asked to clarify certain provisions of FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, relating to accounting for the costs of exploratory wells and exploratory-type stratigraphic test wells (both referred to generally as exploratory wells in this Interpretation) that are in progress at the end of a period and that are determined not to have found proved oil and gas reserves before issuance of the financial statements for the period. The Board has been advised that oil and gas producing enterprises are following differing accounting practices for those wells. Those practices are described in Appendix A.

INTERPRETATION

2. If an exploratory well or exploratory-type stratigraphic test well is in progress at the end of a period and the well is determined not to have found proved reserves before the financial statements for that period are issued, the costs incurred through the end of the period, net of any

salvage value, shall be charged to expense for that period. Previously issued financial statements shall not be retroactively restated.

EFFECTIVE DATE AND TRANSITION

3. This Interpretation shall be effective for financial statements for fiscal years beginning after December 15, 1981 and for interim accounting periods within those fiscal years. Earlier application is encouraged but is not required.

This Interpretation was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Kirk dissented.

Mr. Kirk dissents to issuance of this Interpretation because, in his opinion, the positions stated in paragraphs 5(c) and 7 of this Interpretation, though rejected in this Interpretation, are consistent with the intention of Statement 19. Paragraph 11(d) of Statement 19 expressly defines costs incurred to "drill and equip wells that are not yet completed" as assets.

Mr. Kirk believes that while drilling is still in process, an exploratory well has value; industry experts indicate interests in uncompleted wells can be sold. As of the balance sheet date, therefore, it is entirely appropriate to recognize the costs of an uncompleted well as an asset, though, if significant, disclosure of the subsequent determination that the well was unsuccessful may be required. Moreover, Mr. Kirk believes that Statement 19's intent was to avoid suggesting the need for an impairment of value assessment for the capitalized costs of exploratory wells in process, similar to the assessment explicitly required in Statement 19 (paragraph 28) for unproved properties.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: BACKGROUND INFORMATION

4. Paragraphs 19, 27, 31, 33, and 39 of Statement 19 are relevant to this matter. The substance of the relevant portions of paragraphs 19, 27, 31, and 33 is as follows:

- a. The costs of drilling exploratory wells shall be capitalized as part of the enterprise's uncompleted wells, equipment, and facilities pending determination of whether the well has found proved reserves. That determination is usually made on or shortly after completion of drilling the well.
- b. If the well has found proved reserves, the capitalized costs of drilling the well shall be reclassified as part of the enterprise's wells and related equipment and facilities.
- c. If the well has not found proved reserves, the capitalized costs of drilling the well, net of any salvage value, shall be charged to expense.

Paragraph 39 states that:

Information that becomes available after the end of the period covered by the financial statements but before those financial statements are issued shall be taken into account in evaluating conditions that existed at the balance sheet date, for example, in assessing unproved properties (paragraph 28) and in determining whether an exploratory well or exploratory-type stratigraphic test well had found proved reserves (paragraphs 31-34).

5. The Board has been advised that three different accounting practices are now being followed for exploratory wells that are in progress at the end of a period and that are determined not to have found proved reserves before financial statements are issued.
 - a. Some enterprises believe the costs incurred on the well through the end of the period should be charged to expense. They believe that the determination, after the end of the period, that the exploratory well has not found proved reserves (is a "dry hole") confirms a condition that existed all the time. That condition is not affected by whether the well was completed at the end of the period. They believe, therefore, that paragraph 39 of Statement 19 requires charging the costs incurred through the end of the period to expense.
 - b. Other enterprises agree with the view in subparagraph (a) and in addition believe that the costs to complete the well should be accrued and charged to expense as of the end of the period. The subsequent determination that the well has not found proved reserves means that the total cost of the well represents a loss. They believe that the total loss, both already incurred and yet to be incurred, should be recognized at the end of the period. Those who hold the view stated in subparagraph (a) disagree because they feel continued drilling in the next period should not affect the results of the previous period. They believe that the costs of unsuccessful exploratory wells under Statement 19 are not comparable to costs of contractual commitments requiring recognition of losses.
 - c. A third group of enterprises capitalizes the costs incurred through the end of the period as uncompleted wells, equipment, and facilities. They believe that paragraphs 19, 27, 31, and 33 of Statement 19 require capitalization of the costs of an exploratory well until a determination is made of whether the well has found proved reserves. Because the determination cannot be made until the well is completed, the costs should not be charged to expense before the date of completion. They believe that paragraph 39 of Statement 19 is

only applicable to exploratory wells that have been completed but not yet evaluated at the end of a period. Determination before issuance of financial statements that a completed well had not found proved reserves would result in charging the costs of the well to expense in the period of completion.

6. A draft of a proposed Interpretation, *Accounting for Exploratory Wells in Progress at the End of a Period*, was released for comment November 26, 1980. The Board received 48 letters of comment in response to the proposed Interpretation. Certain of the comments received and the Board's consideration of them are discussed in paragraphs 7-10.

7. Most of the respondents who disagreed with the proposed Interpretation believe that the proper method of accounting for an exploratory well in progress at the end of a period is that described in paragraph 5(c) of this Interpretation (i.e., that such costs should remain capitalized until the well is completed and determined to be dry). Those respondents relied heavily on the language in paragraph 19 of Statement 19, which provides that the cost of drilling an exploratory well shall be capitalized pending determination of whether the well has found proved reserves, and on paragraph 31, which addresses accounting when drilling of an exploratory well *is completed*. They believe that Statement 19 requires capitalization of the costs of an exploratory well until the well is completed, at which time an assessment is made and the cost of an unsuccessful well is charged to expense. They believe that paragraph 39 of Statement 19 does not apply to an exploratory well in progress at the end of a period.

8. Paragraph 198 of Statement 19 refers to capitalizing "the costs of drilling all exploratory wells *pending* determination of success or failure, that is, *pending* determination of whether proved reserves are found" (emphasis added). Paragraph 205 further explains that "the existence of future benefits is not known until the well is drilled. Future benefits depend on whether reserves are found." Also, that "an exploratory well must be assessed on its own, and the direct discovery of oil and gas reserves can be the sole determinant of whether future benefits exist and, therefore, whether an asset should be recognized." The Board believes that the existence of future benefits is an essential characteristic of an asset. An exploratory well that is determined to be dry is not an asset. The timing of that determination has no bearing on the obligation to account for the nonexistence of the asset at the end of the period in yet-to-be issued financial statements for the period. A determination that is made after the end of the period but before financial statements for that period are issued is not an event that eliminates previously existing future benefits; the determination merely provides information as to whether future benefits did or did not exist at the end of the period and, therefore, whether an asset did or did not exist at that time.

9. Many respondents expressed concern that to finalize the proposed Interpretation would impair the comparability of financial statements of (a) different enterprises that issue their financial statements at different dates and (b) individual enterprises that issue financial statements at different times after the end of interim and annual accounting periods. They also believe that gathering data relating to exploratory wells in progress at the end of a period would

be costly and might delay the release of financial statements. The Board believes these problems are not unique to this issue and exist for all contingencies that exist at the date of the financial statements.

10. A number of respondents requested that the Board define the term "before the issuance of financial statements" as it appears in this Interpretation. The Board did not do so because such a definition is beyond the scope of this Interpretation and is not unique to accounting for exploratory wells.