MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Duke (ext. 297)		
Subject:	Minutes of the January 12, 2005 Board Meeting: Suspended Well Costs	**Date:**	January 17, 2005
cc:	Leisenring, Bielstein, L. Smith, Petrone, E. Smith, Mahoney, Gabriele, Polley, Swift, Getz, Sutay, Thompson, Posta, Project Team, FASB Intranet		

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic: Amendment to FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, for Suspended Well Costs

Basis for Discussion: Memorandum dated January 3, 2005

Length of Discussion: 9:00 am to 10:00 am

Attendance:

Board members present: Herz (by phone), Trott, Batavick, Crooch, Young, Schipper, and Seidman

Board members absent: None

Staff in charge of topic: Westerlund

Other staff at Board table: L. Smith, Golden, E. Smith, Kispert, and Duke

Outside participants: None

Summary of Decisions Reached:

The Board discussed issues related to the proposed FASB Staff Position (FSP) FAS 19-a, "Accounting for Suspended Well Costs," that would amend the guidance for suspended well costs in FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies.* The Board made the following decisions:

1. The scope of the proposed FSP should include both exploratory and exploratory-type stratigraphic wells (collectively referred to as exploratory wells).

2.. Exploratory well costs should continue to be capitalized when (a) the well has found a sufficient quantity of reserves to justify completion as a producing well and (b) the enterprise is making sufficient progress assessing the reserves and the economic and operating viability of the project. If either of these criteria is not met, or if an enterprise obtains information that raises substantial doubt about the economic or operational viability of the project, the exploratory well costs should be assumed to be impaired and its costs, net of any salvage value, should be charged to expense.

3. An enterprise should consider a number of indicators that demonstrate an enterprise is making sufficient progress in assessing the reserves and economic and operating viability of the project. The Board asked the staff to include an additional indicator related to the existence of transportation and other infrastructure that is either subject to active negotiations or solely pending capacity availability.

The Board directed the staff to develop additional disclosure requirements for discussion at a future Board meeting including disclosures of (1) the amount of capitalized exploratory well costs, (2) a rollforward of the net changes from period to period in the capitalized costs, and (3) the amount of costs that have been capitalized for a period greater than one year after the completion of drilling and the amount of projects for which those costs relate. The Board also will discuss potential transition alternatives at a future meeting.

Objective of Meeting:

The purpose of this meeting was for the Board to consider whether they agree with (a) the proposed scope of the project, (b) the application of the guidance to exploratory-type stratigraphic wells, (c) the criteria for the continued capitalization of exploratory well costs after the completion of drilling, (d) the factors to consider when evaluating whether an enterprise is making sufficient progress on assessing the reserves and the project, and (e) the disclosures. The staff also asked the Board whether it agrees that the appropriate form to issue the guidance to amend Statement 19 is a Board-directed FSP.

Matters Discussed and Decisions Reached:

1. Mr. Westerlund began the meeting by stating that the original purpose of the meeting was for the Board to consider whether to approve the posting of a proposed FSP for public comment that would amend the guidance for suspended well costs in Statement 19. However, the FASB staff has determined that it needs to provide the Board with additional information on the transition provisions of the proposed FSP; therefore, the staff would not be asking for approval to post the proposed FSP for public comment at this meeting. He stated that the additional information will be provided to the Board as quickly as possible but requested that the Board consider the other aspects of the proposed FSP at this time.

2. Mr. Westerlund explained that at the September 2004 EITF meeting, the Task Force discussed EITF Issue No. 04-9, "Accounting for Suspended Well Costs." Issue 04-9 addressed whether there are circumstances that would permit the continued capitalization of exploratory well costs beyond one year after the completion of drilling. The Task Force generally agreed that an amendment to Statement 19 is required to permit exploratory well costs to be carried as an asset for a period longer than one year. Accordingly, the Task Force removed Issue 04-9 from its agenda and asked the Board to consider an amendment to Statement 19 to address the issue. In November 2004, the

Board agreed to add a narrow scope project to it's agenda to consider an amendment to Statement 19. Mr. Westerlund stated that the staff provided the Board with a draft of a proposed FSP that would amend the guidance for accounting for suspended well costs in Statement 19.

3. Mr. Westerlund said that the proposed FSP provides guidance for exploratory well costs and exploratory-type stratigraphic wells, which he referred to collectively as exploratory wells. The proposed FSP would permit the continued capitalization of exploratory well costs if the well has found a sufficient quantity of reserves to justify its completion as a producing well and either (a) the enterprise is making sufficient progress assessing the reserves and the economic and operating viability of the project or (b) the determination of proved reserves is dependent solely on the pending availability of the capacity of existing infrastructure (for example, capacity of an existing pipeline). The proposed FSP provides a number of factors for an entity to consider when assessing whether it is making sufficient progress assessing the reserves and the project.

4. Mr. Westerlund stated that he had received feedback from certain Board members and others regarding the second criterion in the proposed FSP—that is, the determination of proved reserves is dependent solely on the pending availability of the capacity of existing infrastructure. The primary concern was why these reserves would not be classified as proved if the only remaining factor for the determination of proved reserves was the pending capacity of existing infrastructure. Mr. Westerlund noted that a number of constituents believe that this criterion should be removed as it is currently stated but be included as a factor to be considered when determining whether the entity is making sufficient progress. He then opened the topic for deliberation.

5. Mr. Trott began the deliberations by confirming that the scope of the proposed FSP includes both exploratory wells and exploratory-type stratigraphic wells.

He asked for comments on the staff's recommendation of the scope. All Board members agreed on the scope of the proposed FSP.

6. Mr. Herz noted that the scope only applies to those entities that use the successful-efforts method of accounting.

7. Mr. Trott asked for comments on whether the criteria for continued capitalization of exploratory well costs was appropriate.

8. Ms. Seidman asked Mr. Westerlund if the specific recommendation was to move the criterion of pending availability of existing infrastructure to an indicator that states that an entity is making sufficient progress. Mr. Westerlund responded that it was his recommendation.

9. Ms. Schipper stated that the pending availability of the capacity in the existing infrastructure should be used in considering the economic and operating viability of the project.

10. Six Board members [LS, KS, GB, ET, and BH] agreed with the criteria for capitalization. Mr. Young stated that he did not agree with the criteria for continued capitalization or indicators that an entity was making sufficient progress. He explained that the proposed FSP provides an opportunity for companies to manipulate earnings through the capitalization of exploration costs with a low probability of success. Further, Mr. Young said that the proposed FSP did not represent an improvement in financial reporting from the guidance included in Statement 19.

11. Mr. Trott stated that the first criteria for carrying well costs as assets was to determine if a sufficient quantity of reserves had been found to justify the exploratory well's completion as a producing well. If the exploration found a dry hole, the first criterion would not be met. Continuing to carry the cost of a successful exploration is a positive development in that the costs incurred

represent a potential future economic benefit. Mr. Trott stated that he looks to the proposed criteria to provide the time to make the evaluation of the reserves and the project. The ability to suspend the costs while making the evaluation is important information to have in the financial statements, he added.

12. Mr. Batavick stated that a company could not go forward with suspending the well costs unless sufficient quantities of oil and gas have been found. When a dry hole is found, the company writes it off. He explained that when exploration proves there is a flow of oil and gas, further drilling may need to be done to determine the reserves as commercially viable.

13. Mr. Young clarified his use of the term *dry hole*. He stated that he did not mean to use dry hole in a way that conveyed that no oil and gas had been found. He stated that exploration may find oil and gas, but if the oil and gas is not commercially viable at the time, it is accounted for as a dry hole.

14. Mr. Herz asked if the proposed FSP prevents the deferral from continuing for an extended period of time. Mr. Trott replied that circumstances would determine how long the deferral could last. The removal of the time limit is more consistent with the objectives-based effort than having the one-year restriction.

15. Mr. Young stated his concern was with how the fundamental nature of oil and gas exploration is changing. He said that accounting should not change to accommodate the higher risk profile of the industry. He added that the user community will not have more confidence in the financial statements because the FASB has accomodated the industry by allowing an entity more than one year to turn a well into a proved resource.

16. Mr. Batavick stated that one of the major metrics used by oil industry analysts is the margin per barrel. The margin per barrel should include all costs, including exploratory costs. Analysts compare companies in the industry to see how successful and efficient each company is in their exploration and

lifting activities. An oil analyst would likely want to see all of the costs, including exploratory costs, capitalized in an oil development property.

17. Ms. Seidman questioned if there was some way to change the proposed evaluation to include the likelihood of a positive outcome. Mr. Herz stated a potential modification could be that the company is not just making progress toward assessing the reserves but that the company also believes there is no reason to think that the project will not be successful. Mr. L. Smith stated that the staff could consider a modification.

18. Mr. Trott asked if the Board members were prepared to express a view on the proposed criteria for evaluation, subject to certain revision. Most of the Board members said they were prepared to do so. Mr. Young stated that until he had received feedback from the user community, he was uncomfortable with removing the one-year bright line in Statement 19.

19. Mr. Trott asked Mr. Westerlund to distribute an updated draft of the proposed FSP to the Board before coming back to discuss transition. He then moved the discussion to disclosures.

20. Mr. Westerlund stated that the proposed disclosures would require an entity to disclose in the notes to the financial statements the amount of capitalized exploratory well costs that are pending the determination of proved reserves. An enterprise also shall describe the activities that it has undertaken to (a) evaluate the reserves and the project, (b) the information still required to classify the associated reserves as proved, and (c) the estimated timing of when the evaluation of the reserves will be completed. Mr. Westerlund stated that a Board member asked the staff to consider an alternative disclosure. This alternative focuses the qualitative disclosures on the amounts of exploratory well costs that have been capitalized for a period longer than one year after drilling has been completed. The alternative would require an entity to disclose the total amount of suspended well costs that have been capitalized for a period longer than one year or some other indication of the aging of those costs. Additionally, qualitative information would be required

only for those costs capitalized for longer than one year. He then opened the floor for deliberations.

21. Mr. Trott stated that the intent of the disclosure requirement is to provide information concerning what is considered an asset today because enough sufficient reserves have been found to move forward. He added that the disclosure should focus on the wells in which it takes longer than one year to determine viability.

22. Mr. Batavick had several concerns. He was able to ascertain that total suspended well costs for at least two U.S. major oil companies represented less than 1 percent of total assets. The proposed disclosures were substantial for such a small asset. Some of the information required by the proposed disclosure may take on characteristics of forward looking information, and there are concerns about having this information in the notes of audited financial statements. Additionally, some of the circumstances surrounding the time it takes to bring a project to fruition may be sensitive, both politically and competitively. Mr. Batavick agreed that the amount of suspended well costs should be disclosed, that the emphasis on disclosures should be on projects going out more than one year, and that changes from year to year could be provided; however, the other information is not needed.

23. Mr. Trott stated that the success rate in finding reserves is a major driver of value, and while the amount may be small, the impact on the success rate of exploration is material.

24. Mr. Young asked if there were current disclosure requirements. Mr. Batavick replied that there were no specific disclosure requirements for suspended well costs. Mr. Young stated that because this directly impacts reported earnings, when any project that had gone for over a year gets written off or recategorized, the disclosure should occur on an interim basis. Mr. Trott asked if disclosures were wanted in this area. The Board responded affirmatively.

25. Mr. Herz questioned whether information about the estimated reserves for a particular well should be provided. Mr. Westerlund stated that the staff would look into that question, but that there are restrictions on disclosing reserves that are not yet proved.

26. Mr. Trott directed the staff to work on the proposed disclosures including a rollforward amount and the impact of interim reporting.

27. Mr. Golden stated that if a significant change in status occurs during a quarter that is related to year-end disclosures, the company is required to have a quarterly disclosure. Arguably, when there is a material change in the status of a well, current literature already requires a quarterly disclosure.

28. Mr. L. Smith stated that the FASB staff recommends that the amendment to Statement 19 be affected through an FSP. In terms of process, a Board member has the opportunity to write an alternative or dissenting view for inclusion in the FSP. he Board agreed that the appropriate form to issue the guidance to amend Statement 19 is a Board-directed FSP.

<u>Follow-up Items</u>:

None.

<u>General Announcements</u>:

None.