Reflections on the Attempt to Set a Comprehensive International Accounting Standard for the Oil and Gas Industry

Alex Russell
Aberdeen Business School

Linda Jenkins
Aberdeen Business School

This paper reviews the current state of the development of an international accounting standard for the oil and gas industry and the working draft discussion paper (WDDP) issued by the International Accounting Standards Board (ISAB) in 2009. Nichols (2007) outlined a history of international accounting standards in the oil and gas industry and it may be helpful to view this paper as a sequel to Nichols' paper. Repetition will be kept to the minimum level necessary for comprehension.

According to the WDDP the original project began in 1998 to consider:

a. The extent to which the costs of finding, acquiring and developing minerals or oil & gas reserves should be capitalised;

b. The methods of depreciating (or amortising) capitalised costs;

c. The degree to which quantities and values of mineral or oil & gas reserves and resources, rather than costs, should affect recognition, measurement and disclosure; and

d. The definition and measurement of minerals and oil & gas reserves and resources. (IASB, 2009, page 4)

This consideration resulted in an Issues Paper of over 400 pages on the Extractive Industries[1] and was issued in November 2000. By way of contrast with the objectives stated above, the Issues Paper stated its objectives to be: To promote a common understanding of the accounting issues, the importance of those issues, and the potential for improving existing financial reporting in **upstream activities** in the extractive industries;

[1] The issues paper was basically a discussion paper.

b. To provide a comprehensive analysis of the major issues in financial reporting in upstream activities in the extractive industries and the alternatives for resolving those issues. This analysis is intended to facilitate a full and informed discussion with, and obtain input from, financial statement preparers and users, professional accountants, financial market regulators, and others who use or are interested in financial reporting in the extractive industries. This Issues Paper summarises the ranges of views (with pros and cons of the alternatives) that are advocated by those interested in financial reporting in the extractive industries. Unless explicitly stated, these views and arguments are not to be taken as views held by, or arguments of, the Steering Committee;

c. To solicit comments from interested parties on the appropriate financial reporting standards and guidelines that should be developed by the International Accounting Standards Committee (IASC) Board for the extractive industries; and

d. Be the first step in the development of one or more International Accounting Standards by the IASC Board. Those Standards are expected to address recognition, measurement, presentation, and disclosure issues that are not covered by existing International Accounting Standards and, further, are expected to provide guidance in applying existing International Accounting Standards to activities that occur in upstream activities in the extractive industries. (IASC, 2000, pages 14-15).

It is worth recalling these objectives, especially the range of views deemed to be desirable, when reviewing the approach adopted by the WDDP working group, which is the subject of this paper.

The Issues Paper received 52 comment letters, some of which may be construed as lobbying on behalf of the maintenance of current discretionary powers that are vested in the preparers of financial statements (see Asekomeh *et al.*, 2006; and Asekomeh *et al.*, 2008). There has, of course, been a long history of resistance to change in the regulation of oil and gas financial statements as evidenced by the research literature consequential to the attempts by the Financial Accounting Standards Board to remove the full cost (FC) accounting method in 1977 (see, for example, Collins and Dent, 1979; Collins *et al.*, 1979; and Collins *et al.*, 1982). Some of this research also highlighted the part that lobbying for accounting standards plays in setting accounting standards (Deakin, 1989; and Gorton, 1991).

Consequently, this may explain the apparent *gently as she goes* approach developed by the IASB in response to users' reactions to the Issues Paper.

The IASB did issue what was termed an interim statement (IFRS 6, Exploration for and Evaluation of Mineral Resources) in December 2004. IFRS 6 ran to 22 pages, one of which consisted of dissenting opinions from four Board members, some 380 or so pages short of the Issues paper length and essentially allowed current practices used by oil and gas companies to be continued (see Nichols, 2007). It even resulted in one company, Dana Petroleum PLC, opting to use both the full cost and successful efforts methods simultaneously in their financial statements, which is quite an achievement for the IASB, given their mission of reducing variation in accounting practice (Dana Petroleum, 2006).

Working Draft Discussion Paper- for information only (IASB, 2009)

The WDDP is part of the ongoing project restarted by the IASB in 2004. This draft was produced by seven staff of the national accounting standard-setters in Australia, Canada, Norway and South Africa (IASB, 2009). No representatives from the standard setting bodies of the USA or the UK were invited to join this research group, despite the huge contribution that standard setters from the US and the UK have made to the extant oil and gas accounting regulations. The WDDP states that:

> The IASB has agreed that if it adds the extractive activities project to its active agenda, it will regard the discussion paper as the first stage in its due process. In that case, the IASB would publish an exposure draft as the next phase of such a project (IASB, 2009, page 3).

Must the process be so tedious and prolonged given that many of the current IFRSs actually are apposite and relevant to what oil and gas companies publish?[2] The working group produced draft conclusions which, once finalised, may be used as the basis for questions to which they will seek answers from interested parties. There are ten such draft questions outlined in the WDDP. These questions are listed below since they summarise the draft recommendations of the WDDP and they also provide the basis for critical analysis of the process.

[2] This relevance of current IFRSs is acknowledged in the WDDP (IASB, 2009)

Before these questions are considered it is helpful to reflect on the research undertaken by the working group. The working group's draft conclusions were influenced by the responses it received to a series of 34 interviews[3] which the group conducted with key users of extractive industries financial statements (IASB, 2009). There is a real problem with the approach adopted. The working group adhered to the general view that financial statements are primarily intended to provide useful information to the capital markets and, consequently, the 34 interviewees are drawn exclusively from the capital market sector, and clearly are what might be termed sophisticated users.

Part of the problem of integrating the oil and gas industry within the extractive industries umbrella for financial reporting purposes is that it is fundamentally different than other parts of the extractive industries both in public perception and more importantly in the political and social aspects of its activities. These differences are reflected in the quantity and, arguably, even in the quality of the information users expect in the financial statements[4]. The IASC/IASB have long accepted the distinctive nature of the oil and gas industry for financial reporting purposes, but now, for cost efficiency reasons perhaps, it prefers to blur that distinctiveness.

The distinctiveness crystallises in the attention and media scrutiny given to all activities of the oil and gas sector. The financial statements of the sector should provide information to a wide range of users and it is questionable whether the capital market user is even the dominant user in this case. For example, governments, environmental groups, political groups, social campaigners and fiscal authorities are a few of the user groups for whom these reports are a significant source of information. By restricting their questionnaire to capital market experts, there is a potential bias in the guiding principles used by the WDDP in deciding what is useful to users of financial statements of oil and gas companies. Examples of this bias are better left to the review of the draft questions.

Draft conclusions of the WDDP and potential questions: The first question posed by the working group related to the scope of the extractive activities:

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[3] Some of the interviews were conducted face-to-face and some by telephone (IASB, 2009).

[4] One example of this is the discounted value of reserves required to be reported by US listed oil and gas companies (FASB, 1982).

Question 1: Scope of the extractive industries: The project team proposes that the scope of an extractive activities IFRS should include only upstream activities for minerals, oil, and natural gas. Do you agree? Are there other similar activities that should also fall within the scope of an IFRS for the extractive activities? If so, please explain what other activities should be included within the scope and why (IASB, 2009, page 9).

Question 1 Response: The Issues Paper apparently included other activities such as geothermal projects but, thankfully, the working group concluded that it is better to restrict the range of extractive activities. Do they really need to ask this question? The more important question is whether or not the definition encompasses too many types of organizations. This topic is dealt with in question 2.

Question 2: Approach: The project team proposes that there should be a single accounting and disclosure model that applies to extractive activities in both the minerals and oil & gas industries. Do you agree? If not, what requirements should be different for each industry and what is your justification for differentiating between the two industries (IASB, 2009, page 12)?

Question 2 Response: The mining and oil industries are different. Wars are fought over the control of oil resources and the economic fortunes of countries possessing oil reserves is dependent on overcoming the many challenges that that possession poses for countries (see, for example, El-Gamal and Jaffe, 2009). Perhaps of equal significance are the often complex financial arrangements that are in place to fund the huge outlays for oil projects. These arrangements may involve many parties and the economic substance of the agreements may be far from clear (IASC, 2001). This feature of the complexity of funding arrangements for the exploration and production activities of the oil and gas industry feature further distinguishes it in terms of risk from other parts of the extractive industries.

Question 3: Definitions of minerals and oil & gas assets and resources: The project team proposes the use of mineral reserve and resource definitions established by the Committee for Mineral Reserves International Reporting Standards and the oil & gas reserve and resource definitions established by the Society of Petroleum Engineers (in conjunction with other industry bodies) in an IFRS for the extractive activities. Do you agree? If not, how should minerals or oil & gas reserves and resources be defined for an IFRS (IASB, 2009, page 40)?

Question 3 Response: The WDDP describes the role of reserves in the following manner:

> Broadly speaking, the underlying purpose of reserve and resource definitions is to communicate information about the quantity of minerals or oil & gas that is estimated to exist in a deposit and may be recoverable. However, identifying the definitions of reserves and resources that should apply in the financial reporting of minerals and oil & gas extractive activities is not straightforward, primarily because there is no single, generally accepted definition of reserves and resources that applies to both minerals and oil & gas (IASB, 2009, page 16).

It also devotes 39 pages to discussion of definitions, classifications and disclosure of reserve information. The WDDP conclusion is to recommend that oil and gas companies should use the Petroleum Resource Management System (PMRS) definitions for the oil and gas industry. During the period in which the working group carried out its research the US Securities and Exchange Commission (SEC) was also revisiting the definitions of reserves and they published their "Modernization of Oil and Gas Reporting" regulations in 2008 (SEC, 2008). According to SEC 2008:

> The revisions and additions to the definition section in Rule 4-10(a) of Regulation S-X14 update our reserves definitions to reflect changes in the oil and gas industry and markets and new technologies that have occurred in the decades since the current rules were adopted. Many of the definitions are designed to be consistent with the PRMS definitions (SEC, 2008, page 10)

Basically, the SEC has recognised the differences between the definitions used in their framework with those used by PRMS and have brought their definitions broadly into line with those of the PRMS. The 2008 161 page SEC publication has, to a large extent, pre-empted the work of the IASB. Alas, the IASB seems reluctant to save time and effort and simply adopts the new US definitions even though this step would go a considerable way towards ensuring consistency and comparability between IASB and US regulations. The working group concludes:

> The release of the SEC revisions to its oil & gas reserves definitions has not changed the project team's view that the PRMS (and the CRIRSCO Template definitions for the mining industry) are the definitions that should be assessed for comparability. Even though the revised SEC oil& gas definitions are broadly comparable to the PRMS, the project team regards the PRMS as

> more suitable for use in financial reporting because it offers a more complete classification system because of its comprehensive classification of resources. (IASB, 2009, page 12).

It will be interesting to see how commentators react to this stance by the IASB.

Question 4: Minerals or oil and gas asset – recognition: The project team proposes that legal rights, such as exploration rights or extraction rights, should form the basis of the minerals or oil & gas asset. The asset is recognised when the legal rights are acquired. Information obtained from subsequent exploration and evaluation activities and development works undertaken to access the minerals or oil & gas deposit would both be treated as enhancements of the legal rights asset. Do you agree with this analysis for the recognition of a minerals or oil & gas asset? If not, what assets should be recognised and when should they be initially recognised (IASB, 2009, page 54)?

Question 4 Response: It seems unexceptional to recognise the oil and gas asset on acquisition of the legal right. The wording of the sentence "Information obtained....legal rights asset" is far from precise. Do they mean outlays on further exploration and development activities should be capitalised (subject to impairment) or do they really mean information should be evaluated and treated as an enhancement of the asset? Is it intentionally left vague to leave open the question of using current values as the basis for determining the value of the asset?

Question 5: Minerals or oil & gas asset – unit of account selection. The project team's view is that the geographical boundary of the unit of account would initially be defined according to the exploration rights held. As exploration, evaluation and development activities take place, the unit of account will progressively contract until it becomes no greater than a single area, or group of contiguous areas, for which the legal rights are held and which is managed separately and would be expected to generate largely independent cash flows. In addition, the project team's view is that the components approach in IAS 16 *Property, Plant and Equipment* should apply in determining the items that are accounted for as a single asset.

Do you agree with this being the basis for selecting the unit of account of a minerals or oil & gas asset? If not, what should be the unit of account and why (IASB, 2009, page 65)?

Question 5 Response: Does this conclusion signal the end of the full cost (FC) method, without the WDDP explicitly stating that this is the case, and thereby possibly avoiding the controversy and research activity that previous attempts to eliminate FC have engendered? Clearly, restricting the unit of account to what is essentially an independent cash generating resource has the effect of eliminating full cost as far as it is currently recognised. And the WDDP's statement that:

> The project team's view on initial recognition, as outlined in Chapter 3, is that the information obtained from both successful and unsuccessful exploration and evaluation activities improves the understanding of the geology of the exploration property. Consequently, the costs of these activities should be capitalised because they are an enhancement to the asset even though sufficient information may not yet be available to indicate the existence of economically recoverable reserves (IASB, 2009, page 87).

appears to give more leeway to companies to capitalise an expenditure and leave it capitalised until there is evidence there are insufficient economically recoverable reserves, which may span a few accounting periods. Essentially, the IASB is grasping the nettle and attempting to remove the full cost method. At the same time it is appeasing the proponents of FC by deferring the writing- off of expenditure under a modified SE method, as prudence might suggest, in favour of keeping the expenditure as a potential asset.

Such an approach may appease oil companies who would otherwise be concerned about raising capital with a potentially dire-looking balance sheet. It does, of course, raise the prospect of future disgruntled lenders seeking recompense against whomever they can blame for what they may perceive, in hindsight, to be non-assets appearing on balance sheets. The IASB may be trying to square the circle here. This dilemma has, of course, been dealt with historically by allowing the use of both FC and SE accounting methods.

Question 6 Testing exploration assets for impairment. The project team's view is that exploration assets should not be tested for impairment in accordance with IAS 36 *Impairment of Assets*. Instead, these assets should be tested for impairment whenever evidence is available to suggest that full recovery of the carrying amount of an exploration asset is unlikely. Under this view, the asset would not need to be tested for impairment if, at the reporting date, the evidence needed to make that assessment is not yet available or is inconclusive. The project team also proposes that an entity

should disclose why it considers that the carrying amounts of its exploration assets are not impaired.

Do you agree with the project team's view that IAS 36 should not be applied to exploration assets and that impairment testing is only necessary when evidence is available that suggests the carrying amount might be impaired? If not, what type of impairment test do you think should apply to exploration assets (IASB, 2009, page 92)?

Question 6 Response: This issue was addressed in the comments above relating to question 5. Basically it is possible that the hard evidence of impairment might not be observed until some years down the exploration and production phase and, consequently, early expenditure may remain capitalised.

Question 7 Minerals or oil & gas asset - measurement. This chapter identifies current value (such as fair value) and historical cost as potential measurement bases for minerals and oil & gas assets. The research found that, in general, users believe that measuring these assets at either historical cost or current value would provide only limited relevant information. The project team's view is that these assets should be measured at historical cost and that, in addition, detailed disclosure about the entity's minerals or oil & gas assets should be provided to enhance the relevance of the financial statements (see Chapters 5 and 6).

In your view, what measurement basis should be used for minerals and oil & gas assets and why? This could include measurement bases that were not considered in the discussion paper. In your response, please explain how this measurement basis would satisfy the qualitative characteristics of useful financial reporting information (IASB, 2009, page 96).

Questions 7 Response: This question only appears well into the discussion paper; and yet it strikes right at the heart of the issues which the WDDP is addressing. What is the real value of an oil and gas exploration and production company? Research evidence and basic common sense suggest that it is the value of its oil and gas reserves (see, for example, Wright and Brock., 1999; and Berry and Wright, 2001). The working group, as stated above, chose to carry out its research by interviewing capital market experts, i.e. experts who make a living by demonstrating their capabilities in valuing oil and gas companies, allegedly. Is it surprising that they opined they would not have faith in the directors' own estimates of the value of their company's reserves? To do so might undermine their own status as leaders in reserve valuation.

So the working group's decision to be advised by the views of the capital market has contributed to the view that historical cost remains the most objective, measureable and verifiable basis for preparing financial statements for oil and gas companies. And now the real paradox emerges. Despite this reluctance to give credence to the directors' value of their company's reserves by using those valuations as an integral part of the financial statements, nonetheless it is deemed essential that reserve value information be supplied by the directors as supplementary information.

This disclosure is essentially what happens currently in the US. Do we really need a major comprehensive standard that begins to mirror so closely the present reporting regime in the US? Alternatively, is there a case for reconsidering reserve recognition accounting as an alternate reporting mechanism for the oil and gas industry (see Deakin and Deitrick , 1982)?

Question 8: Disclosure objectives. The project team proposes that the disclosure objectives for extractive activities are to enable users of financial reports to evaluate:

a. The value attributable to an entity's minerals or oil & gas assets;

b. The contribution of those assets to current period financial performance; and

c. The nature and extent of risks and uncertainties associated with those assets.

Do you agree with those objectives for disclosure? If not, what should be the disclosure objectives for extractive activities and why?

Question 8 Response: As discussed above, clearly these values should be disclosed, but more fundamentally perhaps they should be at the heart of the financial statements not merely a useful addendum. Reserve value disclosure in the oil and gas industry has been the subject of previous criticism by industry experts (see Johnston, 2003).

Question 9: Disclosures that meet the disclosure objectives. The project team proposes that the types of information to be disclosed in the notes to the financial statements should include:

a. Quantities of proved reserves and proved plus probable reserves, with the disclosure of reserve quantities presented separately by commodity and by material geographical areas;

b. The main assumptions used in estimating reserves quantities, and a sensitivity analysis;

c. A reconciliation of changes in the estimate of reserves quantities from year to year;

d. A current value measurement that corresponds to reserves quantities disclosed with a reconciliation of changes in the current value measurement from year to year;

e. Separate identification of the exploration, development and operating cash flows for the current period and as a time series over a defined period (such as five years); and

f. Separate identification of production revenues by commodity.

Would disclosure of these categories of information provide relevant information to users? Are there any other types of information that should be disclosed? Are there any reasons why any of these categories of information should not be required to be disclosed as part of a complete set of financial statements (IASB, 2009, page 138)?

Question 9 Response: The disclosure of more rather than less information about reserves seems desirable and the suggestions above look sensible although they may not represent an improvement over current disclosure requirements mandated by the SEC. Setting accounting standards is an expensive business.

Question 10: Publish what you pay disclosure proposals. The project team's research found that the disclosure of payments made to governments provides information that would be of use to capital providers in making their investment and lending decisions. It also found that providing information on certain categories of payments to governments might be difficult (and costly) for some entities, depending on the type of payment and the specifics of their accounting system.

In your view, is a requirement to disclose, in the notes to the financial statements, the payments made by an entity to governments on a country-by- country basis justifiable on cost-benefit grounds? In your response,

please identify and quantify (if possible) the benefits and the costs associated with the disclosure of payments to governments on a country-by-country basis IASB, 2009, page 159).

Question 10 Response: This disclosure suggestion seems timely and desirable.

Conclusion

Oil and gas companies generally go the extra mile in disclosing additional information in their financial statements. The financial reports are perceived sensibly as a means of marketing the company by disclosing, albeit selectively, information about their activities. The IASB should perhaps look at ways of standardising the disclosures and as stated above find ways of having a more meaningful, values-based approach at the heart of the preparation of the financial statements. The proposed mixture of HC statements and current value disclosure is questionable and may lead to accusations of mixing incompatible bases in financial statement preparation (see Grinyer, *et al.*, 2003). The oil, and gas industry is uniquely important to geo-political and environmental interests across the world. There are many issues that should be covered in the comprehensive standard. For example, it could provide guidance on accounting for carbon emissions trading for the industry. Carbon emissions is an issue which has added piquancy for the oil and gas industry and deserves specific mention in a comprehensive oil and gas accounting standard; the IASB and the FASB are undertaking a joint project to develop comprehensive guidance for accounting professionals in general with an IFRS scheduled for 2011 (IASB, 2010). A one-stop comprehensive standard for the oil and gas industry i.e. one that contains the elements relevant to the industry that are currently hidden in extant, and forthcoming, IFRSs, and one that has reserve value at the heart of the preparation of the financial statements would appear to be a desirable, if costly, objective. The working draft discussion paper falls considerably short of meeting that objective.

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