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Standardizing oil and gas accounting in the US in the 1970s: Insights from the perspective of regulatory capture

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Abstract

Attempts by the Financial Accounting Standards Board (FASB) to standardize oil and gas accounting in the 1970s has been referred to as the "most politicised accounting argument ever" (Van Riper, 1994, p.56). Marking the only instance in which the Securities and Exchange Commission (SEC) has declined to support the FASB's standards, the failure of the FASB to limit accounting method choice has had lasting implications with divergent methods still practised by oil and gas companies today. This study presents a narrative of this development and specifically examines the events through the lens of regulatory capture theory to show that the industry was successful in capturing the regulatory process and securing its preferred outcome.

Keywords

accounting regulation, accounting standard setting, full cost accounting, oil and gas accounting, regulatory capture theory, successful efforts accounting

Introduction

It is widely accepted that the process of developing accounting standards is politically charged (Solomons, 1978; Zeff, 1978; Solomons, 1983; Gorton, 1991; Sikka, 1992; Walker & Robinson, 1993; Carnegie & West, 1997; Ryan *et al*., 1999; Zeff, 2002; Georgiou, 2004). The presence of politics in the standard setting process was particularly evident when the US Financial Accounting Standards Board (FASB) attempted to standardize oil and gas accounting practices in the 1970s. From the time the FASB added the project to its agenda in 1973 until the time the issue was finally put to rest in 1979 the FASB, the Securities and Exchange Commission (SEC) and members of Congress were the targets of unprecedented lobbying pressure from industry constituents opposed to the FASB's attempts to limit accounting alternatives (Gorton, 1991).

The issue at the heart of the controversy concerned the methods used to account for costs incurred in searching for and developing oil and gas reserves. These geological and geophysical activities, now more widely known as exploration and evaluation activities, have associated costs that can extend to hundreds of millions of dollars. The two basic methods that evolved to account

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for these costs are known as the full cost method and the successful efforts method. Under the full cost method all acquisition, exploration, and drilling costs, including those relating to unsuccessful activities, may be capitalized and carried forward until such time as they can be written off against revenue from successful projects (Flory & Grossman, 1978). In contrast, under the successful efforts method, only those costs that relate directly to successful projects can be matched against revenue from the successful project (Katz, 1985).

Often related to the method chosen to account for oil and gas exploration and evaluation is the size of the company: small, independent companies, known as "juniors" in the industry, engaged solely in upstream activities typically use the full cost method, whereas the larger companies, such as Exxon Mobil and Shell, operating across both upstream and downstream phases of the industry generally use successful efforts accounting. The sheer size and economic resources of these large companies, known as "majors" in the industry, means that they can afford to write off expenses related to unsuccessful exploration efforts and still maintain impressive profit and balance sheet results (Frazier & Ingersoll, 1986). In contrast, the juniors tend to prefer the full cost method because capitalization improves balance sheet ratios and stabilizes earnings figures, which in turn assists with obtaining debt finance and attracting investors as they search for oil and gas (Amernic, 1979; Frazier & Ingersoll, 1986).

In 1973 the FASB proposed to eliminate full cost accounting and require that the successful efforts method be used by oil and gas companies to account for exploration and evaluation costs. The stakes were high for companies using the full cost method. Pioneer Corporation, for example, adopted full cost accounting in 1973 and almost immediately restated its assets from US$2 million to US$6 million and had planned expansion to US$25 million for 1977 (Pioneer Corporation, 1977). Another junior exploration company, Bow Valley Industries, noted that a change to successful efforts accounting would result in a restatement of earnings from US$4.5 million to a loss of US$1 million (Bow Valley Industries, 1977). An intense lobbying effort was launched by full cost proponents and the standard setting process ultimately failed when the SEC opted not to endorse the FASB's standard (Gorton, 1991; Van Riper, 1994).

This paper offers a new insight into the oil and gas accounting controversy by constructing an historical narrative of this event and examining the issue from the perspective of regulatory capture theory. By providing another lens through which to view the controversy, this research supplements existing knowledge of this event by arguing that the process of setting a standard for the oil and gas industry in the US was captured by those it was intended to regulate. While regulatory capture theory is most commonly used to demonstrate an industry's capture of a regulatory agency, in this paper the theory will be used to demonstrate the industry's capture of the regulatory *process* such that it was able to secure favourable regulation.

To advance this analysis, the paper will consist of four sections. The following section presents a review of earlier studies that followed the FASB's attempt to standardize oil and gas accounting and discusses the value of using a narrative approach to understand this event. Next the theory of regulatory capture is explained in detail along with its applications in extant research. Then the history of the oil and gas accounting controversy in the US will be discussed and analysed from the perspective of regulatory capture theory. Finally, conclusions will be presented along with limitations and opportunities for future research.

A narrative of the standard setting process

A substantial amount of academic research followed the FASB's attempt to standardize oil and gas accounting practice in the 1970s. Many of these studies focused on the market effects of the

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proposed change in accounting method. Dyckman and Smith (1979), Dyckman, (1979), Collins and Dent (1979), and Lev (1979) conducted event studies that attempted to predict whether the elimination of the full cost method would result in negative returns for those companies requiring a change in accounting policy. Bandyopadhyay (1994), Deakin (1979), Johnson and Ramanan (1988), and Lilien and Pastena (1981) documented empirical differences between oil and gas producing companies associated with the use of successful efforts and full cost accounting following the failure of the FASB to standardize accounting practice. Full cost firms were shown to be smaller and newer than their successful efforts counterparts (Johnson & Ramanan, 1988), as well as more highly leveraged (Deakin, 1979; Johnson & Ramanan, 1988), associated with poorer financial performance in terms of reported net income, retained earnings, and asset balances (Lilien &Pastena, 1981), and large levels of capital expenditure (Johnson & Ramanan, 1988).

Other studies covering the FASB's standardization efforts documented the FASB's proposals and the arguments for and against full cost and successful efforts accounting (Baker, 1976; Flory & Grossman, 1978; Amernic, 1979). Others proposed alternative value based measures, such as reserve recognition accounting, that could be used in place of, or in addition to, existing methods (Bierman *et al*., 1974; Katz, 1985; Pratt, 1990). Researchers have also included the oil and gas controversy in studies of the economic consequences of accounting (Zeff, 1978; Lev, 1979; Smith, 1981; Larcker & Revsine, 1983) and in arguments relating to the politicization of accounting and the standard setting process (Solomons, 1978; 1983; Gorton, 1991).

While these studies contribute to our knowledge of the proposed elimination of full cost accounting and its effects from a variety of perspectives, they do not provide an historical narrative of this event. Therefore, this paper adopts an interpretational approach (Previts *et al*., 1990) to offer a narrative of the standard setting process from the perspective of the "new" accounting history (Funnell, 1998). While narratives have an important role in all forms of the writing of accounting history, traditional historians see narratives as a means of telling a story that most closely reflects the historical experience and are, in effect, seeking a historical "truth" through narrative (Chua, 1998; Parker, 1999). New accounting historians instead seek to contextualize the narrative in its social, economic, and political domains and describe the past by looking at it through different theoretical lenses (Merino, 1997; Chua, 1998; Funnell, 1998; Gaffikin, 1998; 2011). The purpose of the narrative is not to unearth the truth about the past, but instead to focus on new ways of coming to know about the past by offering form and meaning and supplying interpretations and explanations (Parker, 1999).

Using information available in the public domain, such as primary sources including discussion memoranda and exposure drafts, comment letters from constituents, media releases, minutes of meetings, legislation excerpts, and Congress documents, as well as secondary accounts of events from people involved in the process, the standard setting controversy is re-examined. While the literature has considered the market implications and the politicization and economic consequences arguments associated with standard setting for the oil and gas industry, this inquiry goes further by using the discourse surrounding this event to construct an historical narrative and a reinterpretation of the standard setting process involved through the lens of regulatory capture theory.

Regulatory capture theory

There are several economics-based theories that seek to explain patterns of government regulation of the economy (Posner, 1974; Laffont & Tirole, 1991). These include "public interest" theory, which considers that regulation exists primarily for the protection of the public, and "interest group" or "capture" theory which posits that regulation is provided in response to the demands of

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interest groups (Stigler, 1971; Posner, 1974). The public interest view of regulation would suggest a pluralistic rule-making process, where no one particular interest group is favoured over another (Polsby, 1963; Crenson, 1971; Posner, 1974; Walker & Robinson, 1993; Walker & Mack, 1998). In the interest group conception, an industry subject to regulation mobilizes its power to secure rules that are favourable to its members (Stigler, 1971; Posner, 1974; Mitnick, 1980). Although pluralist views of the accounting standard setting process exist (see e.g. Hussein & Ketz, 1980; 1991; Carpenter & Feroz, 1992; 2001), there is substantial evidence that accounting standards are created, or at least adapted, to suit particular interest groups (see e.g. Hope & Gray, 1982; Johnson & Messier, 1982; Saemann, 1999; Weetman, 2001; Georgiou, 2004). In this paper, it is the capture theory of regulation that will be used to explain attempts to standardize oil and gas accounting in the US.

Stated simply, regulatory capture theory explains situations where regulatory agencies are captured by the industry they are supposed to be regulating (Uche, 2001). Most applications of the theory have focused on the relationship between an industry and the state. A valuable means of investigating state intervention in a situation of monopoly, regulatory capture theory has often been used in studies of the public utilities sectors. Upadhyaya and Mixon (1995), for example, used regulatory capture theory to examine the effect of economic regulation on electric utility prices and found that captured regulatory agencies were likely to respond to the concerns of the utility companies and refrained from pressuring companies to reduce electricity prices to consumers over time. The US telecommunications industry was examined by Duso (2005), who found that the lobbying tactics employed by the industry to avoid regulation were successful in limiting cost increases. Other studies using regulatory capture theory have focused on banking regulation in Russia (Slinko, 2005), nursing home care in Australia (Makkaia & Braithwaite, 1992), banking regulation (Hardy, 2006), and the link between regulatory capture and corruption (Boehm, 2007).

Regulatory capture theory has also been applied in cases where the regulator is a self-governing, professional agency (see e.g. Benston, 1985; Young, 1988; 1991; Roberts & Kurtenbach, 1998). A notable example is a study by Walker (1987), which explored the establishment and early function of the Australian Accounting Standards Review Board (ASRB) during which time he had been a member of the Board. The ASRB was a government-established agency formed for the purpose of enabling greater government and community involvement in the accounting standard setting process, which had up to that time been a joint effort of the professional accounting bodies the Institute of Chartered Accountants and the Australian Society of Accountants.[1] Walker (1987) used Mitnick's (1980) conception of regulatory capture to show that the ASRB had been captured by the accounting profession it was set up to regulate. He argued that the agenda- and standard-setting processes were not determined on the basis of public submissions, but were instead dominated by the preferences of the professional accounting bodies. Further, although the Board was initially representative of various stakeholder groups, by its second year, six of the seven Board members were representatives of the two professional accounting bodies. Using Mitnick's (1980) terminology, Walker (1987) argued that the profession had managed to ensure the "nonperformance" of the Board by influencing procedures, determining priorities, and coordinating the activities of the Board with its own.

Walker's (1987) use of Mitnick's theory is apt because Mitnick's conception focuses on the direct relationship between regulators and the industry, with information playing a central role. The flow of information between the profession and the ASRB, or rather the profession's control of information to the Board, was a key factor in ensuring non-performance by the ASRB (Walker, 1987). Capture is said to occur if:

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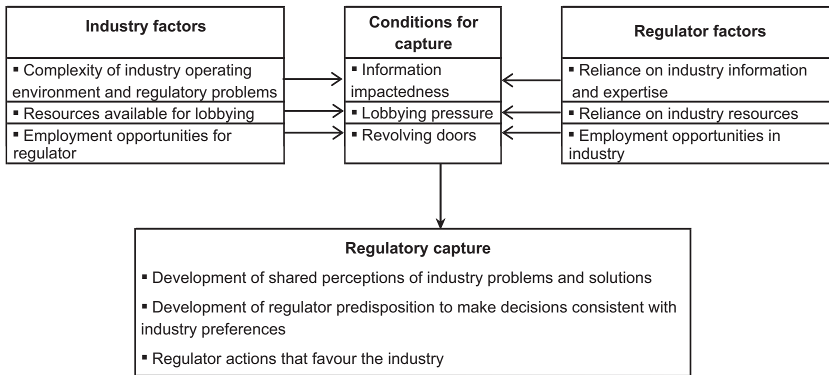

Figure 1. Industry and regulator factors contributing to regulatory capture

> The regulated interest *controls* the regulation and the regulated agency; or if the regulated parties succeed in *coordinating* the regulatory body's activities with their activities so that their private interest is satisfied; or if the regulated party somehow manages to neutralise or insure *nonperformance* (or mediocre performance) by the regulating body; or if in a subtle process of interaction with the regulators the regulated party succeeds in *co-opting* the regulators into seeing things from their own perspective; or if … the basic structure of the *reward system* leads regulators to a community of interests with the regulated party. (Mitnick, 1980, p.95, emphasis in original)

Information is critical to the potential for capture. If the industry subject to regulation operates in an environment of complexity, the information needed to make decisions will also be complex, and is likely to be best understood and interpreted by industry experts. This leads to a condition of "information impactedness" between the industry and the regulatory agency: the regulator must rely on the industry to supply adequate and accurate information. This reliance may result in a predisposition by the regulator to make decisions that favour the industry, particularly if the industry acts opportunistically to secure its preferences.

In addition to information impactedness and industry complexity, Mitnick (1980) considered other factors that contribute to this predisposition of regulatory agencies to take actions consistent with the preferences of the regulated industry. These factors include the existence of "revolving doors" between the regulatory agency and the industry, the resources available for lobbying by the industry, and industry control over the regulator's resources. These factors are summarized in Figure 1.

To create the conditions for capture, Mitnick (1980) describes both industry and regulatory factors. As shown in Figure 1, the complexity of the industry's operating environment and regulatory problems are important factors in the development of information impactedness because the regulatory agency must rely on the specialized expertise held by industry professionals (Mitnick, 1980). When the foundation for rule making relies on the supply and interpretation of information from that same industry, the potential for opportunism by the industry can also contribute to the conditions for capture (Williamson, 1975; Mitnick, 1980).

The industry seeking regulation must not only recognize its interests, it must mobilize its members and lobby the regulator in order to secure the preferred outcome (Stigler, 1971; Peltzman, 1976). This task is made easier when the industry has sufficient resources to devote to lobbying efforts and there is a corresponding reliance of the regulator on the resources provided by industry

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(Stigler, 1971; Peltzman, 1976; Mitnick, 1980). The resources could be in the form of votes, financial contributions, contributed services, or provision of personnel (Stigler, 1971; Peltzman, 1976; Dal Bo, 2006).

The potential for regulatory personnel to gain employment in the industry (and vice versa) may also contribute to the conditions for capture. This describes the notion of "revolving doors", where regulators have had industry jobs before, and/or return to industry after their tenure (Makkaia and Braithwaite, 1992; Dal Bo, 2006). Pro-industry decisions may result from regulators who have come from industry, because they have been "socialized" in an industry environment and are more able to see the concerns of industry as legitimate because of their familiarity with the issues (Makkaia & Braithwaite, 1992; McEnroe & Martens, 1996; Dal Bo, 2006, p.214). The possibility of post-regulatory employment may also lead to the building in of regulatory slack in order to enhance future job prospects (Mitnick, 1980; Makkaia & Braithwaite, 1992; Dal Bo, 2006). While the concept of revolving doors relates specifically to employment in the industry or agency, the possibility that a "community of interests" (Mitnick, 1980, p.95) may develop between industry and regulatory agencies does not necessarily rely on employment. Working relationships, friendships and business connections that develop between individuals that interact over a period of time may also contribute to the willingness and ability of the regulators to see things from the point view of the industry (Mitnick, 1980).

The industry and regulatory factors shown in Figure 1 combine to create the conditions for capture. Capture may be subtle, with a sharing of perceptions of industry problems and solutions. It may develop into a predisposition of the regulator to take actions or make decisions that are consistent with industry preferences, or it may be an overt example of capture where the regulator takes action that favours the industry (Mitnick, 1980).

The oil and gas industry, described as a "political juggernaut" (Stigler, 1971, p.3), presents a unique opportunity for a case study in regulatory capture. Many studies of rule-making activity in accounting have focused on analyses of submissions made to profession-sponsored standard-setting bodies (see e.g. Brown, 1981; 1982; Puro, 1984; Tutticci *et al*., 1994; Tandy & Wilburn, 2000) and have overlooked the influence of government agencies on the development of accounting standards (Walker & Robinson, 1993). While this paper considers the roles of both the FASB and the SEC in the oil and gas issue, the use of regulatory capture theory in this paper does not focus on the capture of a particular regulatory agency by the oil and gas industry. Rather, it focuses on the capture of the accounting standard setting process by the industry in order to provide an explanation for what has been described as one of the most highly politicized accounting arguments ever (Van Riper, 1994).

Oil and gas accounting in the US and regulatory capture

The following sections trace the accounting standard setting process for the oil and gas industry in the US. An historical narrative of the events surrounding the standard setting process is constructed using publically available discourse, which is interpreted using the regulatory capture theory as the theoretical lens. The next section presents the backdrop against which the standardization of oil and gas accounting practices was considered. This is followed by a review of the FASB task force set up to lead the standardization project and its reliance on industry expertise to develop discussion memoranda and exposure drafts. The research then focuses on the intense lobbying efforts of the oil and gas industry and considers the relationships that develop between industry and regulatory participants which contribute to the conditions for capture.

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The beginning of the accounting standard setting process

The controversy surrounding oil and gas accounting in the US can be traced back as far as 1964, when the American Institute of Certified Public Accountants (AICPA), the then standard setting authority, commissioned a study to examine the accounting practices used by oil and gas companies (Van Riper, 1994). The Accounting Principles Board (APB), a committee established by the AICPA to concentrate on the development of accounting theory, received the published research study in 1969. The study's findings essentially supported the use of the successful efforts methods of accounting (Flory & Grossman, 1978; Van Riper, 1994).[2] The report was reviewed again in 1970 with a view to narrowing alternative accounting practices for the extractive industries, however the APB was in the final stages of its demise and the matter was never resolved (Van Riper, 1994).

In 1973, the APB was finally disbanded as a result of criticism regarding its independence and effectiveness, and the FASB took over standard-setting responsibility (Fogarty *et al*., 1994; McEnroe and Martens, 1996). Importantly for the oil and gas controversy that was to follow, the Securities Act of 1934 delegated accounting standard setting powers to the Securities and Exchange Commission (SEC), which, instead of setting its own standards, had allowed the profession (via the FASB and its predecessor bodies) to set accounting standards provided the Commission deemed them satisfactory (Gore, 1992; Fogarty *et al*., 1994; McEnroe & Martens, 1996). In addition, the SEC had considerable power over other accounting matters: companies wishing to issue or trade shares in the US were required to register with the SEC and abide by its rules, which included guidelines as to the form and content of financial reports (Gore, 1992).

When the FASB took over standard setting responsibility in 1973, it did not initially add oil and gas accounting to its agenda (Van Riper, 1994). However, in the same year, war broke out in the Middle East and the US experienced an energy crisis as a result of embargos on oil shipped to the US (Fehner & Holl, 1994; Zeff, 2007). This led to the consideration of national energy strategies and the establishment of the Federal Energy Office to direct efforts to achieve national energy independence (Fehner & Holl, 1994). The Federal Energy Office became the Federal Energy Administration in 1974 and was to operate until 31 December 1977. This agency was made responsible for petroleum allocation and pricing decisions, the provision of energy information and analysis, and for the development of strategic energy conservation policies (Fehner & Holl, 1994).

As part of the national energy strategy, the Energy Policy and Conservation Act was passed in December 1975. Under the Act, the SEC was charged with the responsibility of developing a national energy database and for prescribing the accounting practices that would support the database (FASB, 1978a; Federal Register, 1978). The requirements of the Act were to be met by the end of 1977, which coincided with the expiration of the Federal Energy Administration, and the SEC was authorized to delegate its accounting standard setting responsibilities to the FASB (Katz, 1985; Fehner & Holl, 1994).

Pre-empting this legislation, the FASB had placed "Financial Accounting by Oil and Gas Companies" on its technical agenda and the SEC gave the FASB the task of developing the accounting standard (FASB, 1978a; Flory & Grossman, 1978). As part of its due process, the FASB appointed a task force to lead the project, the purpose of which was to advise and assist the Board in understanding the complex, industry-specific issues (FASB, 1978a).

Complicating the accounting standard setting process – information impactedness and industry complexity

The oil and gas industry is characterized by uncertainty. An oil or gas company may spend millions on exploration efforts only to discover dry holes. If a well is found the time lag between the

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discovery of the resources and their extraction can be up to eight years, and even then selling prices are uncontrollable and volatile (Luther, 1996). Added to these variables are the impact of changing technology, the difficulty of operating in diverse geographical and legal environments, and the politically sensitive nature of world oil markets, all of which combine to make risk "endemic to the industry" (Wise & Spear, 2002, p.3).

As far back as 1775, extractive operations were described as a "lottery in which the prizes do not compensate the blanks, though the greatness of some tempts many adventurers to throw away their fortunes in such unprosperous projects" (Smith, 1775, p.187, cited in Wise & Spear, 2002, p.3). The high-risk nature of the extractive industries has direct implications for financial reporting, which requires that users be able to assess the financial information and use it to make decisions about the allocation of economic resources (McBride & Carroll, 2005). However, as correctly noted by Wise and Spear (2002, p.9), accounting does not deal well with the risky nature of the extractive industries with "regular – even excessive – exercise of particularly subjective judgment" necessitated by reporting entities. Wise and Spear (2000, p.30) have also suggested that the accounting practices of these companies "can at best be described as inadequate and might reasonably be referred to as an outstanding example of accounting flexibility".

Given the industry specific nature of the proposed accounting standard and the potential problems that might arise from efforts to account for complex oil and gas operations, it is reasonable to assume that in the process of setting the standard the Board would seek the knowledge and experience of industry experts in developing the standard. The task force assembled by the FASB initially comprised 18 members, with an additional member added shortly after its formation. Eight of these 19 members were drawn directly from oil and gas companies, comprising the junior exploration and production entities, AMAX Inc., Tesoro Petroleum Corporation, Forest Oil Corporation, Pennzoil Company, and Continental Oil Company, as well as the majors, Mobil Oil Corporation, Standard Oil Company, and Newmont Mining Corporation (FASB, 1978a). The other members were oil and gas experts representing the foremost professional accounting firms, investment banks and financial analyst firms. The Chairman, Dr Horace Brock, was a petroleum expert and Professor of Accounting from North Texas State University (FASB, 1978a). Details of the task force members and their affiliations are presented in Table 1.

Evident from Table 1 is the FASB's reliance on the industry to provide expertise and input to its financial reporting project on oil and gas accounting. This task force was responsible for the development of a discussion memorandum, which took almost a year of deliberations (Van Riper, 1994). The discussion memorandum was the first major milestone in the accounting standard setting process for the oil and gas industry and set forth the various issues related to accounting for oil and gas operations and was intended to be a neutral document and the basis for public comment. However, the issue of the memorandum marked the commencement of an intense lobbying effort by the industry. Public comment came in the form of 140 letters and 39 oral presentations at a public hearing, during which advocates for full costing were vocal and zealous in their support for that method of accounting (FASB, 1978a; Van Riper, 1994).

Due process and public consultation – resources available for lobbying

The lobbying effort launched by the oil and gas industry, and particularly the full cost proponents, was spirited. The economic consequences argument was used to promote the cause of the full cost companies, with T. Boone Pickens, founder and CEO of Mesa Petroleum Co. claiming that without the full cost method he would not have been able to grow his company's assets (largely as a result of capitalizing exploration costs) from US$4 million to US$600 million in 12 years, and to increase

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Table 1. Members of the FASB task force for financial accounting and reporting in the extractive industries

Name	Organization	Affiliate information
Horace Brock, Chairman	Professor of Accounting, North Texas State University	Published expert in the area of petroleum accounting
Martin V. Alonzo	Vice President & Controller, AMAX, Inc	Independent energy company
Peter L. Anker	Vice President, Smith Barney & Co	Investment banking firm
Dean M. Bloyd	Group Vice President, Tesoro Petroleum Corporation	Independent petroleum exploration and production company
Victor H. Brown	Controller, Standard Oil Company (Indiana)	International oil and gas company
John S. Chalsty	Director of Research, Donaldson, Lufkin & Jenrette, Inc	Investment banking firm
Edwin Clemens	Financial Vice President & Treasurer, Forest Oil Corporation	Independent petroleum exploration and production company
Robert C. Drummond	Controller, Exploration & Producing, Mobil Oil Corporation	International oil and gas company
Robert E. Field	Partner, Price Waterhouse & Co	Professional accounting firm
Robert B. Gilmore	Senior Chairman, DeGolyer & MacNaughton	Petroleum industry consulting firm
Norman J. Luke	Group Vice President, Pennzoil Company	Petrochemical corporation
Randal B. McDonald	Partner, Arthur Andersen & Co	Professional accounting firm
David Norr	Partner, First Manhattan Co	Investment banking firm
Richard M. Pollard	Partner, Touche Ross & Co	Professional accounting firm
Stanley P. Porter	Partner, Arthur Young & Company	Professional accounting firm
W. Rowland Reed	Vice President & Controller, Continental Oil Company	Independent oil and gas exploration company
Gerald E. Shorrod	Vice President, First National City Bank	Investment banking firm
Harry Van Benschoten	Controller, Newmont Mining Corporation	International mining company
Ernest C. Janson	Partner, Coopers & Lybrand	Professional accounting firm

revenues from US$1.5 million to US$100 million over the same period (Van Riper, 1994). Another vocal advocate of full cost accounting was J. Hugh Liedtke, CEO of Pennzoil Company and also a member of the FASB's task force (see Table 1). He spoke at the public hearing and accused the FASB of misinterpreting its duties under the Act, arguing that it was not obliged to mandate a single method of accounting. He recommended that both the successful efforts and full cost methods be retained and argued that the FASB requiring a single method of accounting would be akin to "a cookbook that will tell you that you can only cook an egg a certain way" (Liedtke cited in Van Riper, 1994, p.60). T. Boone Pickens was similarly candid at this hearing saying that had the elimination of the full cost method been an issue when his company started he would "have probably been on my knees, pleading for full cost accounting and telling you how much it meant to us" (Pickens cited in Van Riper, 1994, p.59).

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Despite the impassioned written and oral arguments of the full cost advocates, the FASB continued with its standard setting programme and issued its Exposure Draft, entitled Financial Accounting by Oil and Gas Producing Companies, requiring the use of the successful efforts method in July 1977, five months before the statutory deadline (FASB, 1978a; Flory & Grossman, 1978). Again following its due process, the FASB provided an opportunity for public comment on the Exposure Draft. In response, 199 comment letters were received (FASB, 1978a).

These comment letters were analysed to discern the sentiment of respondents and to determine their preferences regarding the full cost versus successful efforts issue. The majority of respondents (146 or 73 per cent) were oil and gas companies, and 95 per cent of these were small, independent oil and gas companies that used the full cost method (the remaining 5 per cent comprised the majors, being, British Petroleum, Exxon Corporation, Mobil Oil Corporation, Phillips Petroleum Co., Royal Dutch/Shell Group, Standard Oil, and Texaco). Of the 199 comment letters received, 61 per cent indicated support for the full cost method, 24 per cent supported the successful efforts method and the balance (16 per cent) made no direct comment on this issue or advocated a completely different approach, such as fair value.

Interestingly, the comment letters also revealed disquiet among the Task Force itself. Fourteen members of the Task Force submitted comment letters to the FASB in respect of the Exposure Draft. Two of the three majors (Standard Oil and Mobil Oil) submitted comment letters indicating their support for the successful efforts method along with Price Waterhouse and Co, while Coopers & Lybrand suggested that both methods be retained. Three other comment letters avoided making direct comment on this issue, however the remaining seven submissions from companies represented on the Task Force contained sometimes forceful arguments against the proposal to eliminate full cost accounting. These submissions were from Tesoro Petroleum, Donaldson, Lufkin & Jenrette, Forest Oil Corporation, Pennzoil Company, Arthur Andersen & Co, First Manhattan Co, and Touche Ross & Co.

Most frank was John S. Chalsty, task force member and managing director of Donaldson, Lufkin & Jenrette Securities Corporation, who stated that he was "very disappointed" at the Exposure Draft and "disagreed wholeheartedly" with its conclusions. Chalsty further stated that he could "hardly believe that it is the FASB's intention to make an irrelevant joke of reported earnings" and that he would urge his analysts and others in his profession to "ignore reporting oil company earnings completely in their evaluation and concern themselves only with cash flow and other operating measures" (FASB, 1978a). Randal B. McDonald, also on the task force and partner of Arthur Andersen & Co., expressed his dissatisfaction with the Exposure Draft and admonished the FASB for not discussing its conclusions with the task force before publishing its proposals (FASB, 1978a).

John Chalsty (see Table 1), in conjunction with 10 other full cost proponents, requested a private meeting with the FASB to discuss the issue further. The meeting took place on 28 September 1977 and a summary of the substantive comments was placed on public record. All of the meeting attendees had submitted individual comment letters in response to the Exposure Draft, and all had indicated vehement opposition to the FASB's proposed standard.

The meeting was dominated by J. Stanford Smith, Chairman and Chief Executive Officer of International Paper Company, which had acquired General Crude Oil for $489 million in 1975 and converted immediately to full cost accounting to "dress up" its financial statements (FASB, 1978a; Van Riper, 1994, p.58). He argued that full cost accounting provided the incentive for management to enter into high risk exploration efforts that would be curbed under successful efforts accounting because of the requirement to expense unsuccessful efforts.

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Smith and the other company representatives argued that the 12-month timeline for financial reporting was at odds with the reality of determining the results of exploration and production operations, which can take between three and eight years (FASB, 1978a). It was also argued that national energy policy would be threatened if full cost accounting was prohibited and that the best solution was to continue to permit both full cost and successful efforts accounting (FASB, 1978a). In his closing comments, Smith again argued for another public hearing stating that it was necessary "due to the makeup of … the FASB" (FASB, 1978a, p.56). When asked to elaborate on this point, Smith said that the FASB and its governing entity, the Financial Accounting Federation, "have members who may be perceived as representing the interests of the major oil companies" (FASB, 1978a, p.57). This seemed to be the feeling of many respondents whose submissions also claimed that the FASB was favouring the major oil companies (FASB, 1978a). One submission noted that not only can the major oil companies "afford the luxury" of using the successful efforts method, but they might in fact prefer it because it prevents smaller companies participating in exploration efforts, and particularly those that involve significant risk (Carolina Pipeline Company, 1977).

Perhaps sensing little sympathy from the members of the FASB, shortly following this meeting, the full cost proponents united to launch a "mortar attack" in Washington (Van Riper, 1994, p.63). Again the International Paper Company led the effort and the other companies in the group, while not in the league of Exxon and BP, were still large entities and had important political connections, especially with senators and members of Congress from oil-producing states (Van Riper, 1994). The group targeted the SEC as well as the Department of Energy, the Federal Trade Commission, and the Department of Justice (Gorton, 1991). Many of these agency representatives indicated that they "hadn't experienced such aggressive lobbying ever before" (Kirk cited in Gorton, 1991, p.34). In fact, SEC Commissioner Roberta Karmel later described the matter as "improperly politicised" (Karmel cited in Gorton, 1991, p.30).

On 6 October 1977 US Senators Haskell and Bartlett introduced an amendment to the Energy Policy and Conservation Act which was designed to make it illegal for any standard setting body to eliminate the full cost method (Gorton, 1991). The amendment argued that the purpose of the Act in establishing a national energy database did not mean that a single method of accounting need be adopted (Gorton, 1991; Van Riper, 1994). During October and November, representations continued to be made to the FASB, the SEC and other policy makers urging reconsideration of the issue. Finally, the "Haskell-Bartlett Amendment" was rejected on 1 December by the Senate-House conference committee (Van Riper, 1994), leaving the way clear for the FASB to continue with its planned elimination of full cost accounting. On 5 December, by a vote of four to three, the FASB formally adopted *Statement of Financial Accounting Standard (SFAS) 19, Financial Accounting for Oil and Gas Producing Companies*, which would see full cost accounting prohibited after a 12-month transition period (FASB, 1978a; Gorton, 1991; Zeff, 2007). Therefore, at least for a period of time, full cost accounting was abolished under SFAS 19 and the FASB was triumphant (Van Riper, 1994; Zeff, 2007).

While this was taking place, the heavily-lobbied Department of Energy was planning hearings to determine the effect of the changes on oil and gas exploration, and the Antitrust Division of the Department of Justice insisted that the SEC analyse the potential effects on competition prior to adopting or approving the new rule (Van Riper, 1994). SEC Chairman, Harold Williams announced that public hearings would take place in early 1978 to consider the issues further (Gorton, 1991; Zeff, 2007). Following these hearings, during which the smaller oil and gas companies using "all of their lobbying might to defend against the imposition of 'successful efforts costing'" (Zeff, 2007, p.58), the SEC declined to support either method and instead issued *Accounting Series*

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Release No.253, which announced a Reserve Recognition Accounting project that would work towards a new method of accounting for oil and gas activities based on current values (Gorton, 1991; Zeff, 2007; Wright & Gallun, 2008). The lobbying efforts had apparently paid off; the regulatory process had been immobilized.

With the SEC having withdrawn its support for SFAS 19, the FASB issued *Statement of Financial Accounting Standard (SFAS) 25, Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies*, which essentially suspended the requirement that successful efforts accounting be used (FASB, 1978b; Zeff, 2007; Wright & Gallun, 2008). A former Professional Accounting Fellow at the SEC commented that this solution was a "way out of this very difficult box": it allowed the issue to be put off for a while, placating both the full cost coalition and the FASB, as well as taking steps to improve oil and gas financial reporting (Hall cited in Gorton, 1991, p.39).

By 1980, however, the SEC had abandoned the reserve recognition project and requested that the FASB develop a standard which would simplify and enhance the disclosures made under either the full cost or successful efforts method (Van Riper, 1994). The result of this was *Statement of Financial Accounting Standard (SFAS) 69, Disclosures about Oil and Gas Producing Activities*, which was issued in November 1982 and is still in place today (FASB, 1982; Wright & Gallun, 2008). Oil and gas marks the only instance in which the SEC has declined to support the FASB (Van Riper, 1994; Zeff, 2007). Interestingly, in March 1979, six months following the decision not to support SFAS 19, International Paper Company sold General Crude Oil for US$650 million (Van Riper, 1994).

The above discussion provides an illustration of two factors that Mitnick (1980) considers necessary for regulatory capture: information impactedness and lobbying by the industry. The oil and gas industry is complex both in terms of actual operations and the accounting for those operations, and this created the need for specialist knowledge and experience which was garnered from industry representatives and industry-affiliated experts (refer again to Table 1). Some of these same industry representatives formed part of a concerted and ultimately successful lobbying effort against the proposal to eliminate full cost accounting. A third factor contributing to regulatory capture relates to "revolving doors" or the potential for industry employment and/or relationships between the regulators and the industry, which is discussed next.

Capturing the standard setting process – creating a community of interests

The relationships that develop between industry and regulatory participants in standard setting processes are important to the potential for regulatory capture. These relationships can develop from industry-based employment opportunities available to regulatory personnel (and vice versa), leading to a situation of revolving doors of employment and the forging of shared perceptions.

In the case of the oil and gas controversy, as part of its due process, the FASB actually engaged a task force comprised of industry professionals to direct its financial reporting project for oil and gas accounting and develop its discussion memorandum. So, at least initially, the group in charge of developing the standards *was* in fact the industry that was to be regulated by them. While on the one hand it seems reasonable that the FASB would engage experts to assist them in developing the standard, this also creates at least the potential for conflicts of interest and opportunistic behaviour by industry participants.

Also scrutinized during the standard setting process was the supposed bias of the FASB. Many of the comment letters, including some of those put forward by task force members themselves, indicated that the FASB's proposal to eliminate full cost accounting was a function of favouritism

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for the major oil companies at the expense of the smaller, independent companies (FASB, 1978a). While the FASB's predecessor, the APB, was often accused of catering to "external constituencies" (Meyer, 1974, p.188), the full-time employment status of FASB members was intended to overcome this potential bias. However, although Board members were required to sever ties with their former employers, it is pertinent to note that immediately prior to his appointment to the FASB, Robert E. Mays, who was on the Board at the time of the oil and gas accounting controversy, was the Controller of Exxon Corporation (Adebayo & Coffman, 2007). Three other of the Board members were former partners of the (then) "Big 8" accounting firms, that would likely have major oil and gas companies as clients. The former affiliations of the Board members would not have necessarily resulted in favouritism toward the major oil and gas companies, but at the very least, the perception of bias was reasonable.

Once the lobbying effort of the full cost coalition shifted to Congress and the SEC, their targets were well selected. Recall that Senator Dewey F. Bartlett, with co-sponsor Senator Floyd K. Haskell, introduced to Senate an amendment to the Energy Policy and Conservation Act which proposed to make the elimination of full cost accounting illegal (Van Riper, 1994). Senator Bartlett's family had long been involved in the oil and gas industry, with his father establishing the Keener Oil and Gas Company in Oklahoma in the 1900s (Keener Oil and Gas Company, 2010). Senator Bartlett inherited the company from his father and developed a reputation as a champion for oil and gas issues during the energy crisis, which was evident by his co-sponsorship of the Haskell-Bartlett Amendment.

Even at the SEC level the full cost group had a potential sympathizer. Before joining the Commission, SEC Chairman Harold Williams, who was ultimately responsible for vetoing the FASB's SFAS 19, had been on the Board of Phillips Petroleum, which was at the time an independent oil and gas exploration and production company (Gorton, 1991; ConocoPhillips, 2010).[3] In a later interview, Williams indicated that SFAS 19 "did in itself seem to me to be a political decision that … [would] adversely affect a lot of the smaller … independents" (Williams cited in Gorton, 1991, p.38). Consistent with the notion in regulatory capture theory that a "community of interests" can affect the actions of the regulator, Williams also indicated that his time on the Board of Phillips Petroleum had given him "some sense of the … inadequacy of the various methods of accounting" (Williams cited in Gorton, 1991, p.38). Williams was also critical of the FASB's decision on the matter, stating that "fact that the vote was 4-3 at the FASB itself was significant [in] suggesting they really hadn't solved anything" (Williams cited in Gorton, 1991, p.39).

The SFAS 19 dissenters were Board members Arthur L. Litke, Ralph E. Walters, and Robert E. Mays. As already noted, Mays had joined the Board from Exxon Corporation. He declined to support SFAS 19 because he believed that the successful efforts method did not portray the unique economic consequences of oil and gas exploration and discovery (FASB, 1977). Litke was also likely to have some "community of interests" with the full cost companies having joined the FASB from the position of Chief Accountant at the Federal Power Commission (FPC). The FPC was a US government agency responsible for regulating the interstate activities of the electric power and natural-gas industries and, in 1971, issued an order requiring companies to use the full cost method in their reports to the FPC (FASB, 1977). Walters, who was a partner in Touche Ross & Co before joining the Board, dissented on similar grounds, also arguing that a fair value approach would be preferable to either the successful efforts or full cost method (FASB, 1977).

The combination of regulator reliance on information, industry participation, lobbying pressure, and business relationships, results in a potent force that can significantly impact the accounting standard setting process. Interpreted through the theoretical lens of regulatory capture theory, the narrative of the oil and gas controversy shows the accounting standard setting process from a fresh

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perspective. Factors unique to the oil and gas industry (including the complexity of the operating environment, the considerable resources available for lobbying, and the "revolving doors" of employment in regulatory roles), combine with the factors unique to the regulator (including the reliance on information provided by industry experts, reliance on industry resources, and the "revolving doors" of employment in industry roles) to create the conditions for capture. The regulatory process becomes captured when there is a sharing of perceptions between the regulator and the industry being regulated, a development of a predisposition on the part of the regulator to make decisions consistent with the preferences of the industry being regulated, actions by the regulator that favour the industry being regulated. In the case of the oil and gas industry and the proposal to eliminate full cost accounting, the regulatory body was unsuccessful. Interestingly, this marks the only instance in which the SEC has declined to support the FASB (Van Riper, 1994).

Conclusions, limitations and future research

This paper used the discourse available in the public domain to construct an historical narrative of the attempt to standardize accounting practices for US oil and gas companies. By offering a reinterpretation of this event through the lens of regulatory capture theory, it is argued that the standard setting efforts failed because the regulators were captured by industry constituents, and specifically by those opposed to the elimination of the full cost method of accounting. The complexity of the industry and its accounting practices contributed to create information impactedness in so far as the FASB relied on industry representatives and affiliated experts to assist in its understanding of the issues faced by the industry and the potential solutions to them. As noted, a frequently cited argument by industry representatives was that the economic consequences of the FASB's proposal would adversely affect the nation's energy policy. The substantial lobbying resources available to the industry to put pressure on the standard setter, as well as SEC and Congress representatives, were significant contributory factors to the failure of the FASB's efforts to set an agreeable accounting standard for the oil and gas industry. It was also evident that many of the key players involved in the process of developing the standard, and in its demise, had some "community of interests" with the industry (Mitnick, 1980). This occurred to some degree because the regulator relied on the industry to provide information and expertise, for example the task force members. However, it also resulted from key regulatory players, such as Harold Williams and Arthur Litke, having been "socialized" in the industry through prior employment and business connections (Makkaia & Braithwaite, 1992; Dal Bo, 2006, p.214).

In the case of the setting of an accounting standard for the US oil and gas industry, industry and regulatory factors combined to provide the right conditions for capture. Although due process procedures are in place to provide a framework to guide the setting of accounting standards, this case provides an example of how the process of setting a standard – from the development of a task force, to the issue of preliminary discussion memoranda, to the solicitation of public comment, and publication of the eventual accounting standard – can be influenced by information impactedness and the complexity of an industry, lobbying pressure from industry constituents, and the revolving doors of professional affiliation.

The interpretation of this event through a narrative reconstruction of events, and through the lens of regulatory capture theory, has provided a fresh insight into our understanding of the standard setting process for the oil and gas industry. There are, however, limitations to this approach. The construction of a narrative necessarily gives a privileged position to one set of explanations over another (Funnell, 1998), and subjective interpretation is not only unavoidable, it is expected (Previts *et al.*, 1990; Funnell, 1998; Gaffikin, 1998). In addition, the choice of

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regulatory capture theory as a lens through which to examine this event may have presupposed the outcome of this study by biasing the selection of data and discussion of results. Further, by selecting regulatory capture theory other theories, which may also be valid, have been necessarily excluded from consideration. However, the oil and gas issue has been examined from many perspectives (e.g. economic consequences, political power perspectives, studies of market effects) and regulatory capture was selected as an apt means to examine an historical event from a fresh perspective.

There are also limitations specific to this study: the financial contributions made to the Financial Accounting Foundation, which in turn finances the FASB activities, have not been examined. This provides an opportunity for future research in the vein of other studies which have examined the implications of the funding models of standard setters and their potential dominance by "big business" (Sikka, 1992; Carnegie & West, 1997; Cortese *et al*., 2010). Also a potential avenue for future research is the members of the Foundation, how they are appointed, and how they select the FASB members. The potential for the Foundation to select individuals they feel will "come up with the 'right' answers" (Gore, 1992, p.96) would be a valuable supplement to our understanding of the standard setting process, as would a study of "who appoints the appointers?" (Gore, 1992, p.100). Similarly, the relationship between government agencies and private sector regulatory bodies, for example the SEC and the FASB, could be examined to further consider the circumstances which create the conditions for regulatory capture.

This case raises important and disturbing issues in relation to the process of setting accounting standards, particularly in an age of globalization. It has been shown that powerful industry personalities and organizations were able to exercise their will in the setting of an enduring oil and gas accounting standard for the US in the 1970s. On a global level, such power is exerted on a larger scale, possibly to the detriment of national jurisdictions or industries that are unable to amass the influence of more powerful players.

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Notes

1. The Australian Society of Accountants became the Australian Society of Certified Practising Accountants in July 1990 and then CPA Australia in 2000 (CPA Australia, 2011).
2. Recall from the introduction that the successful efforts method requires that costs relating to unsuccessful ventures be expensed immediately, whereas under the full cost method they may be capitalized and carried forward until they can be written off against revenue from successful projects.
3. Phillips Petroleum merged with Conoco Inc in 2002. Interestingly, Harold Williams also became the first president and CEO of the J. Paul Getty Trust. At the time of his death in 1976, J. Paul Getty, founder of the Getty Oil Company, was worth an estimated US$2 billion (Lenzner, 1985).

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