

DRAFT FOR DISCUSSION PURPOSES

EXPOSURE DRAFT

**GUIDANCE NOTE ON ACCOUNTING FOR OIL & GAS
PRODUCING ACTIVITIES (REVISED)**

(LAST DATE FOR COMMENTS: JANUARY 1, 2010)



**Research Committee
The Institute of Chartered Accountants of India
NEW DELHI**

EXPOSURE DRAFT

**GUIDANCE NOTE ON ACCOUNTING FOR OIL & GAS PRODUCING
ACTIVITIES (REVISED)**

The following is the Exposure Draft of the “Guidance Note on Accounting for Oil & Gas Producing Activities (Revised)”, issued by the Research Committee of the Institute of Chartered Accountants of India, for comments. The Committee invites comments on any aspect of this Exposure Draft. Revisions made in the draft of the Revised Guidance Note vis-à-vis the existing Guidance Note are shown in the revision marks (track change mode) along with the comments/reasons for such revision/change. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

*Comments should be submitted in writing to the Secretary, Research Committee, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to be received not later than **January 1, 2010**. Comments can also be sent by e-mail at research@icai.org*

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Marked copy: This is a 'marked copy', wherein proposed additions vis-à-vis the existing Guidance Note are shown as underlined, whereas proposed deletions are shown in strike-through mode.

Note: The draft of the revised Guidance Note has been prepared to address the queries and other clarificatory matters raised by various interested parties. The objective of revision is to make improvements and, accordingly, the fundamental approach to accounting for oil and gas producing activities as contained in the existing guidance note has been retained.

GUIDANCE NOTE ON ACCOUNTING FOR OIL AND GAS PRODUCING

ACTIVITIES (REVISED)

(The following is the text of the Guidance Note on Accounting for Oil and Gas Producing Activities, issued by the Council of the Institute of Chartered Accountants of India.)

INTRODUCTION

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| 1. | Oil and gas producing industry, which is extractive in nature, involves activities relating to acquisition of mineral interests in properties, exploration (including prospecting), development, and production of oil and gas. The aforesaid activities are collectively referred to as upstream operations and form the 'Upstream Petroleum Industry'. The industry is commonly referred to as the 'E&P' industry. The peculiar nature of the industry requires establishment of industry-specific accounting principles in relation to expense recognition, measurement and disclosure. |
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OBJECTIVE

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| 2. | The objective of this Guidance Note is to provide guidance on accounting for costs incurred on activities relating to acquisition of mineral interests in properties, exploration, development and |
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	production of oil and gas.
SCOPE	
3.	This Guidance Note applies to costs incurred on acquisition of mineral interests in properties, exploration, development and production of oil and gas activities, i.e., upstream operations. This Guidance Note also deals with other accounting aspects such as accounting for abandonment costs and impairment of assets that are peculiar to the enterprises carrying on oil and gas producing activities. It does not address accounting and reporting issues relating to the transporting, refining and marketing of oil and gas. This Guidance Note also does not apply to accounting for :
a.	Activities relating to the production of natural resources other than oil and gas, and
b.	the production of geothermal <u>resources</u> or the extraction of hydrocarbons as a by-product of the production of geothermal <u>and associated resources</u> .
DEFINITIONS	
4.	For the purpose of this Guidance Note, the following terms are used with the meanings specified :
	<i>Cost Centre</i> : Cost centre is a unit identified to capture costs based on suitable criteria such as geographical or geological factors. Cost centre is not larger than a field in case of Successful Efforts Method and under Full Cost Method, the cost centre is not normally smaller than a country except where warranted by major difference in economic, fiscal or other factors in the country.
	<i>Depreciation</i> : Depreciation is a measure of the wearing out, consumption or other loss of value

Deleted: steam

Deleted: steam or associated geothermal resources

of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined. Depreciation also includes 'depletion' of natural resources through the process of extraction or use.

Development Well : A well drilled, deepened, completed or re-completed within the proved area of an oil or gas reservoir to the depth of a stratigraphic horizon known to be productive.

Exploratory Well : An exploratory well is a well drilled to find a new field or to find a new reservoir in a field previously found to be productive of oil or gas in another reservoir.
Generally, an exploratory well is any well that is not a development well, a service well, or a stratigraphic test well, as those items are defined separately.

Comment [K1]:
REASON FOR CHANGE:
 New definition from SEC/ US GAAP
 - To cover the cases of 're-entry' also

Field : An area consisting of a single reservoir or multiple reservoirs all grouped on or related to the same individual geological structural feature and/or stratigraphic condition. There may be two or more reservoirs in a field which are separated vertically by intervening impervious strata, or laterally by local geologic barriers, or by both. Reservoirs that are associated by being in overlapping or adjacent fields may be treated as a single or common operational field. The geological terms 'structural feature' and 'stratigraphic condition' are intended to identify localised geological features as opposed to the broader terms of basins, trends, provinces, plays, areas-of-interest, etc.

Deleted: A well drilled for the purpose of searching for undiscovered oil and gas accumulations on any geological prospect. An exploratory well is a well that is not a development well, a service well, or a stratigraphic test well, as those terms are defined separately.

Oil and Gas Reserves : Oil and gas reserves are estimated remaining quantities of oil and gas and related substances anticipated to be economically producible, as of a given date, by application of development projects to known accumulations. In addition, there must exist, or there must be a reasonable expectation that there will exist, the legal right to produce or a

	<u>revenue interest in the production, installed means of delivering oil and gas or related substances to market, and all permissions and financing required to implement the project.</u> A oil and gas reserve estimates involve some degree of uncertainty. Uncertainty depends chiefly on availability of reliable geological and engineering data at the time of the estimate and interpretation of data. <u>The term economically producible, as it relates to a resource, means a resource which generates revenue that exceeds, or is reasonably expected to exceed, the costs of the operation.</u>	Comment [K2]: REASON FOR CHANGE:- To align with the new definition given by SEC/ US GAAP - Better articulation: • ‘Economically producible’ instead of ‘commercially recoverable’ • Intention – plan, permits, finances etc. Deleted: Oil and gas reserves are those quantities of oil and gas, which are anticipated to be commercially recoverable from known accumulations from a given date forward.
	Based on relative degree of uncertainty, oil and gas reserves can be classified as ‘Proved Oil and Gas Reserves’ and ‘Unproved Oil and Gas Reserves’.	
	<i>Proved Oil and Gas Reserves :</i> <u>Proved oil and gas reserves are those quantities of oil and gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible—from a given date forward, from known reservoirs, and under existing economic conditions, operating methods, and government regulations—prior to the time at which contracts providing the right to operate expire, unless evidence indicates that renewal is reasonably certain, regardless of whether deterministic or probabilistic methods are used for the estimation. The project to extract the hydrocarbons must have commenced or the enterprise must be reasonably certain that it will commence the project within a reasonable time.</u> A	Comment [K3]: REASON FOR CHANGE: To align with the new definition given by SEC/ US GAAP - Also aligned with the definition of oil and gas reserves. Deleted: Proved oil and gas reserves are those quantities of mineral oil, natural gas and natural gas liquids which, upon analysis of geological and engineering data, demonstrate with reasonable certainty to be commercially recoverable in future from known oil and gas reservoirs under existing economic and operating conditions.
	Proved oil and gas reserves can be classified as ‘Proved developed oil and gas reserves’ and ‘Proved undeveloped oil and gas reserves’.	Deleted: Establishment of current economic conditions includes relevant historical oil and gas prices and associated costs under existing government regulations, if any. Oil and gas reserves, which can be produced economically through application of advanced recovery techniques, are included in proved classification after successful pilot testing.
	<i>Proved Developed Oil and Gas Reserves :</i> <u>Proved developed oil and gas reserves are</u>	

<u>reserves that can be expected to be recovered:</u> (i) <u>Through existing wells with existing equipment and operating methods or in which the cost of the required equipment is relatively minor compared to the cost of a new well; and</u> (ii) <u>Through installed extraction equipment and infrastructure operational at the time of the reserves estimate if the extraction is by means not involving a well.</u>	
<i>Proved Undeveloped Oil and Gas Reserves :</i> <u>Proved undeveloped oil and gas reserves are reserves that are expected to be recovered from new wells on undrilled acreage, or from existing well where a relatively major expenditure is required for recompletion.</u> (i) <u>Reserves on undrilled acreage should be limited to those directly offsetting development spacing areas that are reasonably certain of production when drilled, unless evidence using reliable technology exists that establishes reasonable certainty of economic producibility at greater distances.</u> (ii) <u>Undrilled locations can be classified as having proved undeveloped reserves only if a development plan has been adopted indicating that they are scheduled to be drilled within a reasonable time, unless the specific circumstances, justify a longer time.</u> (iii) <u>Under no circumstances should estimates for proved undeveloped reserves be attributable to any acreage for which an application of fluid injection or other improved recovery technique is contemplated, unless such technique have been proved effective by actual projects in the same reservoir or an analogous reservoir, or by other evidence using reliable technology establishing reasonable certainty.</u>	Comment [K4]: REASON FOR CHANGE: 1) Proposed definition is in line with new definition of SEC/ US GAAP 2) In comparison to the old definition, the new definition is consistent with para 44 of the existing guidance note and does not consider the 'test run' or a 'pilot project' but considers the actual capital expenditure. 3) Use of the words 'testing by a pilot project' - The existing definition has restricted usage keeping in view the restriction in para 44 of the existing guidance note while computing depletion. Deleted: Proved developed oil and gas reserves are reserves that can be expected to be recovered through existing wells with existing equipment and operating methods. Additional oil and gas expected to be obtained through the application of advanced recovery techniques for supplementing the natural forces and mechanisms of primary recovery should be included as proved developed reserves only after testing by a pilot project or after the operation of an installed programme has confirmed through production response that increased recovery will be achieved Deleted: for which Deleted: drilling units offsetting productive units Deleted: Proved reserves for other undrilled units can be claimed only if it can be demonstrated with certainty that there is continuity of production from the existing productive formation. Deleted: should Deleted: advanced Deleted: tests in the area and in the same reservoir
<i>Probable reserves:</i> <u>Probable reserves are those additional reserves that are less certain to be recovered than proved reserves but which, together with proved reserves, are as likely as not to be recovered. When deterministic methods are used, it is as likely as not that actual remaining quantities recovered will exceed the sum of estimated proved plus probable reserves. When probabilistic methods are used, there should be at least a 50% probability that the actual quantities recovered will equal or exceed the proved plus probable reserves estimates.</u>	Comment [K5]: REASON FOR CHANGE: Proposed definition is in line with the new definition under SEC/ US GAAP Comment [K6]: REASON FOR CHANGE: The proposed definition is in line with new SEC/ US GAAP definition. Included in the context of impairment section where the term 'probable reserves' is proposed to be used.

Reservoir : A porous and permeable underground formation containing a natural accumulation of producible oil or gas that is confined by impermeable rock or water barriers and is individual and separate from other reservoirs.

Service Well : A service well is a well drilled or completed for the purpose of supporting production in an existing field. Wells in this class are drilled for the following specific purposes : gas injection (natural gas, propane, butane, or flue gas), water injection, steam injection, air injection, polymer injection, salt-water disposal, water supply for injection, observation, or injection for combustion.

Stratigraphic Test Well : A stratigraphic test is a drilling effort, geologically directed, to obtain information pertaining to a specific geologic condition. Such wells customarily are drilled without the intention of being completed for hydrocarbon production. This classification also includes tests identified as core tests and all types of expendable holes related to hydrocarbon exploration.

Stratigraphic test wells are classified as follows :

a.	<i>Exploratory-type stratigraphic test well</i> : A stratigraphic test well drilled <u>not</u> in a prove area.
b.	<i>Development-type stratigraphic test well</i> : A stratigraphic test well drilled in a prove area.

Comment [K7]:
REASON FOR CHANGE:
 -In line with new SEC definition
 - The words '(sometimes called expendable wells)' are removed as it may create confusion as to the accounting treatment
 - The existence of these words does not add any value to the definition.

Deleted: (sometimes called expendable wells)

Deleted: not

Unit of Production (UOP) method : The method of depreciation (depletion) under which depreciation (depletion) is calculated on the basis of the number of production or similar units expected to be obtained from the asset by the enterprise.

5. The definitions of certain other terms relevant for the Guidance Note are given in Appendix 1.

CLASSIFICATION OF E&P ACTIVITIES AND RELATED COSTS

Acquisition activities	
6.	Activities carried out by an E&P enterprise towards the acquisition of right(s) to explore, develop and produce oil and gas constitute acquisition activities. Once the areas of oil and gas finds are identified, the E&P enterprise approaches the owner who owns the rights for the exploration, development and production of the underground minerals in respect of the property or area. In order to undertake surveys and exploration activities in India, an E&P enterprise has to first obtain a Petroleum Exploration License (PEL) or Letter of Authority (LOA). For engaging in development and production activities, an enterprise has to obtain a Mining Lease (ML). At present, the PEL/LOA and the ML for onshore E&P activities are granted by the State Governments upon recommendation of the Central Government and for offshore E&P activities by the Central Government.
Acquisition costs	
7.	Acquisition costs cover all costs incurred to purchase, lease or otherwise acquire a property or mineral right <u>(proved or unproved)</u>. These include lease bonus, brokers' fees, legal costs, cost of temporary occupation of the land including crop compensation paid to farmers and all other costs incurred in acquiring these rights. These are costs incurred in acquiring the right to explore, drill and produce oil and gas including the initial costs incurred for obtaining the PEL/LOA and ML. Annual licence fees are excluded. <u>In case the acquisition cost pertains to more than one cost center, it should be apportioned to the related cost centers on a reasonable basis.</u> <u>Expenditure incurred before an enterprise has obtained the right(s) to explore, develop and produce oil and gas, i.e., the pre-acquisition costs, e.g., data collection and analysis</u>

Comment [K8]:

REASON FOR CHANGE:**Note 1**

Acquisition cost may relate to an existing asset (say in case of farm-in). Proved or unproved indicates acquisition cost in all such situations and, therefore, has been added to address that issue.

Therefore, the words "(proved or unproved)" included in the acquisition cost to cover:

- farm in activities
- acquisition of participating interest in existing properties

2) Also aligned to US GAAP (Para 15 of FAS - 19)

	costs incurred for the purpose of identifying the oil and gas asset to be acquired, are not considered to be acquisition costs. Such costs are accounted for in accordance with the general principles laid down in the framework for preparation and presentation of financial statements and other applicable accounting pronouncements.	Comment [K9]: REASON FOR CHANGE: Note 2: Treatment of pre-acquisition costs such as the following have been dealt with: 1) Pre- acquisition costs may include - Company formation - Preliminary expenditure - G&A costs - Share issue expenses - Data collection costs - analysis cost for identifying the oil and gas asset to be acquired 2) Justification of such costs to be charged off or to be capitalised per normal standards, i.e. AS - 26 Intangibles 3) Different treatment depending on the nature of items (and related AS): - Share issue expenses - Not covered by AS 26 - Right to use proprietary data, say, seismic - evaluate as intangible under AS 26 (though not related to acquired property, more of a research expenditure) - Expenses on identifying options for buying blocks - charge off 4) Thus not considered as a part of acquisition cost. This is in line with IFRS which excludes pre-acquisition costs.
Exploration Activities		
8.	Exploration activities cover the prospecting activities conducted in the search for oil and gas. In the course of an appraisal programme these activities include but are not limited to aerial geological, geophysical, geochemical, palaeontological, palynological, topographical and seismic surveys, analysis, studies and their interpretation, investigations relating to the subsurface geology including structural test drilling, exploratory type stratigraphic test drilling, drilling of exploration and appraisal wells and other related activities such as surveying, drilling site preparation and all work necessarily connected therewith for the purpose of oil and gas exploration.	2) Justification of such costs to be charged off or to be capitalised per normal standards, i.e. AS - 26 Intangibles 3) Different treatment depending on the nature of items (and related AS): - Share issue expenses - Not covered by AS 26 - Right to use proprietary data, say, seismic - evaluate as intangible under AS 26 (though not related to acquired property, more of a research expenditure) - Expenses on identifying options for buying blocks - charge off 4) Thus not considered as a part of acquisition cost. This is in line with IFRS which excludes pre-acquisition costs.
Exploration Costs		
9.	Principal types of exploration costs cover all directly attributable expenditure. General and administrative costs are allocated to, and included in, the exploration cost, but only to the extent that those costs can be related directly to operational activities of the related cost centre. In all other cases, these costs are expensed as incurred. For example, general and administrative costs such as directors' fees, secretarial and share registry expenses, salaries and other expenses of general management, etc., are recognised as expenses when incurred since they are only indirectly related to operational activities. Exploration costs include depreciation and applicable operating costs of related support equipment and facilities and other costs of exploration.	Comment [K10]: REASON FOR CHANGE: Note 3 "Allocated Indirect Expenditure" 1) This change is pursuant to the withdrawal of Guidance note on expenditure during construction period. IFRS does not allow inclusion of general and administrative overheads, though the directly related expenditure is eligible for inclusion as per IFRS also. Deleted: and allocated indirect Deleted: which Comment [K11]: REASON FOR CHANGE: This is in order to clarify and to avoid implementation difficulties with regard to allocated indirect expenditure. This is also to align with withdrawal of Guidance Note on expenditure during construction period and also in line with AS-10.

	activities that are :
i.	costs of surveys and studies mentioned in paragraph 8 above, rights of access to properties to conduct those studies (e.g., costs incurred for environment clearance, defence clearance, etc.), and salaries and other expenses of geologists, geophysical crews and other personnel conducting those studies. Collectively, these are referred to as geological and geophysical or 'G&G' costs;
ii.	costs of carrying and retaining undeveloped properties, such as delay rental, <i>ad valorem</i> taxes on properties, legal costs for title defence, maintenance of land and lease records and annual licence fees in respect of Petroleum Exploration License;
iii.	dry hole contributions and bottom hole contributions;
iv.	costs of drilling and equipping exploratory and appraisal wells <u>and related analysis</u> ; and
v.	costs of drilling exploratory-type stratigraphic test wells.

Comment [K12]:
REASON FOR CHANGE:
Note 4:
 Change is made to clarify the treatment of G&G costs incurred during the development phase.
 Each phase should consider the G&G costs as per its nature/ timing and should be accounted for accordingly, e.g., exploration G&G – treat as exploration cost and development G&G – treat as Development cost.

Development Activities

10. Development activities for extraction of oil and gas include, but are not limited to the purchase, shipment or storage of equipment and materials used in developing oil and gas accumulations, completion of successful exploration wells, the drilling, completion, re-completion and testing of development wells, the drilling, completion and re-completion of service wells, the laying of gathering lines, the construction of offshore platforms and installations, the installation of separators, tankages, pumps, artificial lift and other producing and injection facilities required to produce, process and transport oil or gas into main oil storage or gas processing facilities, either onshore or offshore, including laying of infield pipelines, the installation of the said

	storage or gas processing facilities.	
Development costs		
11.	Development costs cover all the directly attributable expenditure incurred in respect of the development activities including costs incurred to :	Comment [K13]: REASON FOR CHANGE: Refer note 3 on para 9 above regarding treatment of allocated indirect expenditure. Deleted: and allocated indirect
i.	gain access to and prepare well locations for drilling, including surveying well locations for the purpose of determining specific development drilling sites, clearing ground, draining, road building and relocating public roads, gas lines and power lines to the extent necessary in developing the proved oil and gas reserves;	
ii.	drill and equip development wells (whether successful or unsuccessful), development type stratigraphic test wells and service wells including the cost of platforms and of wellhead equipment such as casing, tubing, pumping equipment and the wellhead assembly;	Comment [K14]: REASON FOR CHANGE: This is to clarify that dry development wells would form part of overall development cost only. This is in line with clarification in para 22 of SFAS 19 (US GAAP)
iii.	acquire, construct and install production facilities such as lease flow lines, separators, treaters, heaters, manifolds, measuring devices and production storage tanks, natural gas cycling and processing plants and utility and waste disposal systems; and	
iv.	provide advanced recovery system.	
Development costs also include depreciation and applicable operating cost of related support equipment and facilities in connection with development activities, and annual license fees in respect of Mining Lease. <u>General and administrative costs are allocated to, and included in, the development cost, but only to the extent that those costs can be related directly to operational activities of the related</u>		

	<u>cost centre. In all other cases, these costs are expensed as incurred. For example, general and administrative costs such as directors' fees, secretarial and share registry expenses, salaries and other expenses of general management, etc., are recognised as expenses when incurred since they are only indirectly related to operational activities.</u>
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Comment [K15]:

REASON FOR CHANGE:

This is in order to clarify and to avoid implementation difficulties with regard to allocated indirect expenditure. This is also to align with withdrawal of Guidance Note on expenditure during construction period and also in line with AS-10.

Production Activities

12. Production activities consist of pre-wellhead (e.g., lifting the oil and gas to the surface, operation and maintenance of wells, extraction rights, etc.) and post-wellhead (e.g., gathering, treating, field transportation, field processing, etc., upto the outlet valve on the lease or field production storage tank, etc.) activities for producing oil and/or gas.

Production Costs

13. Production costs consist of direct and indirect costs incurred to operate and maintain an enterprise's wells and related equipment and facilities, including depreciation and applicable operating costs of support equipment and facilities. Examples of production costs are :
- | | |
|----|--|
| a. | Pre-wellhead costs : |
| | Costs of labour, repairs and maintenance, materials, supplies, fuel and power, property taxes, insurance, severance taxes, royalty, etc., in respect of lifting the oil and gas to the surface, operation and maintenance including servicing and work-over of wells. |
| b. | Post-wellhead costs : |
| | Costs of labour, repairs and maintenance, materials, supplies, fuel and power, property taxes, insurance, etc., in respect of gathering, treating, field transportation, field processing, including cess upto the outlet valve on the lease or field production storage |

		tank, etc.
ACCOUNTING FOR ACQUISITION, EXPLORATION AND DEVELOPMENT COSTS		
14.	There are two alternative methods for accounting for acquisition, exploration and development costs, viz.,	
	i.	Successful Efforts Method (SEM)
	ii.	Full Cost Method (FCM)
Successful Efforts Method		
<i>Description</i>		
15.	Under the successful efforts method, generally only those costs that lead directly to the discovery, acquisition, or development of specific, discrete oil and gas reserves are capitalised and become part of the capitalised costs of the cost centre. Costs that are known at the time of incurrence to fail to meet this criterion are generally charged to expense in the period they are incurred. When the outcome of such costs is unknown at the time they are incurred, they are recorded as capital work-in-progress and written off when the costs are determined to be not productive.	
Full Cost Method		
<i>Description</i>		
16.	Under the full cost method, all costs incurred in acquiring mineral interests, exploration, and development, are accumulated in large cost centres that may not be related to geological factors. The cost centre, under this method, is not normally smaller than a country except when	

Comment [K16]:
REASON FOR CHANGE:
 G&G costs per definition have been considered not directly leading to discover, acquire, or development of specific discrete oil and gas reserves.

Comment [K17]:
REASON FOR CHANGE:
 Paragraphs 16 to 26 dealing with arguments in favour of and against successful efforts method have been moved to appendix 2.

Comment [K18]:
REASON FOR CHANGE:
Note 5
 1) "Prospecting" is removed to avoid confusions as if it is a pre acquisition activity.
 2) Prospecting is inconsistent with the objective mentioned in para 2.
 3) Exploration covers the prospecting activities.
 4) If prospecting is done after acquisition of property, it would be covered in exploration activities. If done before acquisition of property, would be covered as a 'pre-acquisition cost' and dealt with accordingly.

Deleted: 27

Deleted: prospecting

	warranted by major difference in economic, fiscal or other factors in the country. The capitalised costs of each cost centre are depreciated as the reserves in each cost centre are produced.	Comment [K19]: REASON FOR CHANGE: Paragraph 28 to 34 of the existing guidance note dealing with arguments in favour of and against the full cost method have been moved to appendix 2.
Recommendation		Deleted: 35
<u>17</u>	While the arguments in favour of and against the successful efforts method and full cost method are included in Appendix 2 to this Guidance Note, on an overall consideration, the advantages of the successful efforts method far outweigh its disadvantages particularly keeping in view its conceptual superiority over the full cost method. Accordingly, the successful efforts method is recommended to be the preferred method, though an enterprise is permitted to follow the full cost method. The application of these methods is discussed hereinafter.	Comment [K20]: REASON FOR CHANGE: Note 6 Change is made to clarify that in case the acquisition cost pertains to more than one cost centre, it should be allocated on a reasonable basis. - Paras 36/45 of existing guidance note "application of successful efforts/ full cost methods share a specific reference of "in respect of a cost centre, the following costs should be treated as" - Para 38/47 of existing guidance note mentions - the cost referred to in para 36/45 - The above indicates that the accounting treatment is with specific reference to a particular cost center. - This also indicates that a cost centre would include acquisition cost pertaining to that cost center only and therefore, needs division at that stage itself and not at the stage while reaching para 38 of existing guidance note. - If the acquisition cost pertains to more than one cost center, normal concept of apportionment would apply which does not warrant a specific mention in the Guidance Note. Normal purchase price allocations is a general principle on acquisition of combined assets. - Included in para 7 of the draft guidance note
Application of Successful Efforts Method		Deleted: 36
<u>18</u>	Under the successful efforts method, in respect of a cost centre, the following costs should be treated as capital work-in-progress when incurred :	Deleted: 37
	i. All acquisition costs;	
	ii. Exploration costs referred to in paragraph 9 (iv) and (v); and	
	iii. All development costs.	
<u>19</u>	All costs other than the above should be charged as expense when incurred.	Comment [K21]: REASON FOR CHANGE: Note 7: - "Commencement of commercial production" seems to be akin to "establishment of proved developed oil and gas reserves" (refer to definition of proved developed oil and gas reserves) - Accordingly, this aspect is proposed to be clarified. Consistent with this, once the proved developed reserves are established, there should not be additional period of 2 years to establish that these wells are ready for commencement of commercial production. Accordingly, the para is proposed to be modified.
<u>20</u>	When a well is ready to commence commercial production, the costs referred to in paragraph	- The wells would not be transferred to completed wells till they are "proved and developed" stage and not just under "proved" stage.
		Deleted: 38

	18 (ii) and (iii) corresponding to proved developed oil and gas reserves should be capitalised as 'completed wells' from capital work-in-progress to the gross block of assets. With respect to costs referred to in paragraph 18 (i), the entire cost should be capitalised from capital work-in-progress to the gross block of assets. <u>Normally, a well is ready to commence commercial production on establishment of proved developed oil and gas reserves.</u>	Deleted: 36 Deleted: 36 Deleted: There is a rebuttable presumption that Deleted: within two years from the establishment of Deleted: If the well is not ready for commercial production within the aforesaid period, the relevant costs included in capital work-in-progress should be capitalised on the expiry of the aforesaid period of two years.
21	If the cost of drilling exploratory well relates to a well that is determined to have no proved reserves, then such costs net of any salvage value are transferred from capital work-in-progress and charged as expense as and when its status is decided as dry or of no further use. Costs of exploratory wells-in-progress should not be carried over for more than a period of two years from the date of completion of drilling unless it could be reasonably demonstrated that the well has proved reserves and development of the field in which the well is located has been planned with required capital investment such as development wells, pipelines, etc., in which case the costs of the exploratory well can be carried forward without any time limit. <u>A reasonable demonstration that the well has proved reserves may be when the well has found a sufficient quantity of reserves to justify its completion for production and the enterprise is making sufficient progress assessing the reserves and the economic and operating viability of the project.</u> <u>Expenditure incurred on exploratory wells which were written off in past and started producing subsequently, cannot be reinstated.</u>	Deleted: 39 Comment [K22]: REASON FOR CHANGE: Note 8: Issue: Considering the difficult exploration areas in the current context, the establishment of proved reserves may take more than two years. Thus, the two years period for establishment of proved reserves may not be appropriate. - Completion of exploratory drilling does not include analysis and appraisal before proved reserves are declared. - FAS 19, upto 2005, included 1 year period (rebuttable presumption) for this purpose. However, in 2005 this has been changed by removing 1 year period and appreciating that it can be reasonably demonstrated whether there are indications of proved reserves. - It is proposed to continue with the window of 2 years with an additional clarification regarding "reasonable demonstration". By this, the guidance note would allow to continue with such well in the WIP beyond 2 years in case it is reasonably demonstrated that there is sufficient quantity of reserves to justify its completion for production and the enterprise is making sufficient progress assessing the reserves and the economic and operating viability of the project. - Any wells declared dry or of no use, even before 2 years need to be charged-off as per present Guidance Note. - A period of 2 years has been continued (as in the present Guidance Note) to avoid carry forward of an unproductive asset forever.
Depreciation (Depletion)		Comment [K23]: REASON FOR CHANGE: Note 9 Conceptually, a write off is effected only where the expenditure incurred does not have any future economic benefit. In such a situation, if some more expenditure is incurred after the write off, as a consequence of which a resource comes into existence having future economic benefit, only the latter expenditure can be capitalised as per the existing generally accepted accounting principles. ... [1]
22	Depreciation (Depletion) is calculated, using the unit of production method. The application of this method results in oil and gas assets being written off at the same rate as the quantitative	Deleted: 40

	depletion of the related reserve. For the properties or groups of properties containing both oil reserves and gas reserves, the units of oil and gas used to compute depletion are converted to a common unit of measure on the basis of their approximate relative energy content, without considering their relative sales values (general approximation is 1000 cubic meters of gas is equivalent to 1 metric tonne of oil). Unit-of-production depletion rates are revised whenever there is an indication of the need for revision but atleast once a year. These revisions are accounted for prospectively as changes in accounting estimates, i.e., a change in the estimate affects the current and future periods, but no adjustment is made in the accumulated depletion applicable to prior periods.	
<u>23</u>	The depreciation charge or the UOP charge for the acquisition cost within a cost centre is calculated as under :	
	UOP charge for the period = UOP rate x Production for the period	
	UOP rate = Acquisition cost of the cost centre/Proved Oil and Gas Reserves	
<u>24</u>	The depreciation charge or the Unit of Production (UOP) charge for all capitalised costs excluding acquisition cost within a cost centre is calculated as under :	
	UOP charge for the period = UOP rate x Production for the period	
	UOP rate = Depreciation base of the cost centre/Proved Developed Oil and Gas Reserves	
<u>25</u>	Depreciation base of the cost centre should include	
	a.	Gross block of the cost centre (excluding acquisition costs)
	b.	Estimated dismantlement and abandonment costs net of estimated salvage value

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Comment [K24]:
REASON FOR CHANGE:
Note 10:
 - There is no need to mention inclusion of "allocated cost of common production facilities" due to the following:
 Basic costs (Exploration/Development/Production) as per their definitions already include indirect/ allocable costs and thus no need to mention specifically in the depreciation base.

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		pertaining to proved developed oil and gas reserves	
		and should be reduced by the accumulated depreciation and any accumulated impairment charge of the cost centre.	
<u>26</u>		‘Proved Oil and Gas Reserves’ for the purpose of paragraph <u>23</u> comprise proved oil and gas reserves estimated at the end of the period as increased by the production during the period. ‘Proved Developed Oil and Gas Reserves’ for the purpose of paragraph <u>24</u> comprise proved developed oil and gas reserves estimated at the end of the period as increased by the production during the period.↓	Deleted: 44 Deleted: 41 Deleted: 42
Application of Full Cost Method			
<u>27</u>		Under the full cost method, in respect of a cost centre, the following costs should be treated as capital work-in-progress when incurred :	Comment [K25]: REASON FOR CHANGE: This would be redundant since "amended US GAAP definition" of "proved developed oil and gas reserves" has been proposed to be included in para 4. Deleted: additional reserves from advanced recovery techniques are to be considered as proved developed oil and gas reserves only after the required investments have been capitalised.
	i.	All acquisition costs;	Deleted: 45
	ii.	All exploration costs; and	
	iii.	All development costs.	
<u>28</u>		All costs other than the above should be charged as expense when incurred.	Comment [K26]: Refer Note 2 on para 7. This is clearer after clarifying the position with regard to "pre-acquisition cost".
<u>29</u>		When any well in a cost centre is ready to commence commercial production, the costs referred to in paragraph <u>27</u> above corresponding to all the proved oil and gas reserves in that cost centre should be capitalised from capital work-in-progress to the gross block of assets. In respect of oil and gas reserves proved subsequently, the capital work-in-progress corresponding to such reserves should be capitalised at the time when the said reserves are proved. The expenditure	Deleted: 46 Comment [K27]: REASON FOR CHANGE: Refer Note 7 Deleted: 47 Deleted: 45

	which does not result in discovery of proved oil and gas reserves should be transferred from capital work-in-progress to the gross block of assets as and when so determined.
<i>Depreciation (Depletion)</i>	
<u>30</u>	The depreciation should be calculated on the capitalised cost according to the unit of production method as explained in paragraph <u>22</u> above. In case of full cost method, the depreciation charge or the unit of production (UOP) charge for all costs within a cost centre is calculated as under : UOP charge for the period = UOP rate x Production for the period UOP rate = Depreciation base of the cost centre/Proved Oil and Gas Reserves
<u>31</u>	The depreciation base of the cost centre should include - Gross block of the cost centre; - The estimated future expenditure (based on current costs) to be incurred in developing the proved oil and gas reserves referred to in paragraph <u>32</u>; - Estimated dismantlement and abandonment costs net of estimated salvage values (<u>refer to paragraphs 35-37</u>) for facilities set up for developing the proved oil and gas reserves referred to in paragraph <u>32</u>; And should be reduced by the accumulated depreciation and any accumulated impairment charge of the cost centre.
<u>32</u>	‘Proved Oil and Gas Reserves’ for this purpose comprise developed and undeveloped oil and gas reserves estimated at the end of the period as increased by the production during the period.

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Accounting for Production Costs	
<u>33</u>	Production costs, mentioned in paragraph 13 above, become part of the cost of oil and gas produced, along with depreciation (depletion) of capitalised acquisition, exploration and development costs.
Accounting for Cost of Support Equipment and facilities	
<u>34</u>	The cost of acquiring or constructing support equipment and facilities used in E&P activities should be capitalised in accordance with Accounting Standard (AS) 10, 'Accounting for Fixed Assets'. Depreciation on such equipment and facilities should be arrived at in accordance with Accounting Standard (AS) 6, 'Depreciation Accounting', and accounted for as exploration cost, development cost or production cost, as may be appropriate.
ACCOUNTING FOR ABANDONMENT COSTS	
<u>35</u>	Abandonment costs are the costs incurred on discontinuation of all operations and surrendering the property back to the owner. These costs relate to plugging and abandoning of wells, dismantling of wellheads, production, and transport facilities and to restoration of producing areas in accordance with license requirements and the relevant legislation.
<u>36</u>	The full eventual liability for abandonment cost net of salvage values should be recognised at the outset on the ground that a liability to remove an installation exists the moment it is installed. Thus, an enterprise should capitalise as part of the cost centre the amount of provision required to be created for subsequent abandonment. Charge for abandonment costs should not be discounted to its present value. The provision for estimated abandonment costs should be made at current prices considering the environment and social obligations, terms of mining

	lease agreement, industry practice, etc. ¹	Comment [K28]: REASON FOR CHANGE: The concept of discounting proposed to be introduced, may need amendment in AS 29. Para 35 of AS 29 state as under (also refer Appendix, "Illustration C- (3) of AS 29): <i>"The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value."</i> This may also need transitional provision to make it implementable. One paragraph dealing with transitional provisions has been added for discussion purposes. The abandonment cost forms part of carrying value of oil and gas assets. Any adjustment in the abandonment cost should be considered as an adjustment in the carrying value of oil and gas assets to be depleted prospectively. Presently, the unwinding costs and depletion in the past have not been considered here, since transitional provisions may not address an ideal situation
37	No gain or loss should be recognised if only an individual well or individual item of equipment is abandoned as long as the remainder of the wells in the cost centre continue to produce oil or gas. Instead, the asset being abandoned be deemed to be fully depreciated. When the last well on the cost centre ceases to produce and the entire cost centre is abandoned, gain or loss should be recognised.	
CAPITALISATION OF BORROWING COSTS		
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¹AS 29, Provisions, Contingent Liabilities and Contingent Assets, is under revision with a view to require discounting of provisions, where time value of money is material. Once AS 29 is revised to this effect, para 36 would be replaced by the following:

"The eventual liability for abandonment cost net of salvage values should be recognised at the outset on the ground that a liability to remove an installation exists the moment it is installed. Thus, an enterprise should capitalise as part of the cost centre the amount of provision required to be created for subsequent abandonment.. The provision for estimated abandonment costs should be made at current prices considering the environment and social obligations, terms of mining lease agreement, industry practice, etc. Where the effect of the time value of money is material, the amount of the provision should be the present value of the expenditures expected to be required to settle the obligation. The discount rate (or rates) should be a pre-tax rate (or rates) that reflect current market assessments of the time value of money and the risks specific to the liability. The discount rate should not reflect risks for which future cash flow estimates have been adjusted. Changes in the measurement of existing abandonment costs that result from changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation or a change in the discount rate should be added to, or deducted from the related cost center in the current period and would be considered for necessary depletion (depreciation) prospectively. However, the change in the estimated provision due to the periodic unwinding of the discount should be recognized in profit or loss as it occurs. Since abandonment costs do not reflect borrowed funds, the unwinding cost would not be a borrowing cost eligible for capitalization.

Where an enterprise first adopts the above treatment in respect of discounting of provision, the difference (as adjusted by any related tax expense) between the liability in respect of abandonment costs as per revised paragraph 36, existing on the date of adopting the revised paragraph 36 and the liability that would have been recognised at the same date, as per the pre-revised paragraph 36 should be adjusted in the carrying amount of oil and gas assets.

38.	Capitalisation of borrowing costs under the full cost method as well as the successful efforts method should be carried out in accordance with the Accounting Standard (AS) 16, 'Borrowing Costs'. For the purpose of AS 16, all the costs that are classified under capital work-in-progress should be considered as the qualifying asset.	Deleted: 56
IMPAIRMENT OF ASSETS		
39.	Accounting Standard (AS) 28, 'Impairment of Assets', is applicable to E&P enterprises irrespective of the method of accounting used. For the purpose of AS 28, each cost centre used should be treated as a Cash Generating Unit. <u>One or more of the following facts and circumstances indicate that an E&P enterprise should test for impairment during the exploration phase (the list is not exhaustive):</u>	Deleted: 57
	<u>(a) the period for which the enterprise has the right to explore in the specific area has expired during the period or will expire in the near future, and is not expected to be renewed.</u>	Comment [K29]: REASON FOR CHANGE: Note 11: Words "for depreciation (depletion) purposes" are superfluous and thus deleted. This probably gave an indication that impairment is only linked with depreciable pool. However, AS 28 would be applicable at all stages of operations whether exploration, development or production. 2) Indications of impairment in case of an E&P enterprise have been added (taking support from IFRS 6). 3) The clarification as to the base for future cash flows, i.e. 1P, 2P or 3P has been added. This is with reference to IFRS/US GAAP practices.
	<u>(b) substantive expenditure on further exploration activities in the specific area is neither budgeted nor planned.</u>	
	<u>(c) exploration in the specific area have not led to the discovery of commercially viable quantities of reserves and the enterprise has decided to discontinue such activities in the specific area.</u>	
	<u>(d) sufficient data exist to indicate that, although a development in the specific area is likely to proceed, the carrying amount of the exploration asset is unlikely to be recovered in full from successful development or by sale.</u>	

In any such case, or similar cases, the enterprise should perform an impairment test in accordance with AS 28. Any impairment loss is recognised as an expense in accordance with AS 28.

In case of development/ producing fields, the proved reserves would have been established. Accordingly, in case any of the indicators as per the general principles of AS 28 or if any specific indicators exist, its recoverable amount should be determined for the purposes of impairment analysis.

For the purposes of estimating future cash flows, E & P enterprises should consider both proved and probable reserves. For this purpose, full estimate of expected cost of evaluation/ development (i.e., in arriving at the proved reserves) should be considered while applying the impairment test. Further, the estimates of probable reserves should also be adjusted by weighing all possible outcomes by their associated probabilities.. For example, the most likely scenario (with a probability of 60%) may be that probable reserves of say 100 units become proved reserves at 100 units, the potential upside (with a probability of 15%) may be that probable reserves become proved reserves at 110 units, and the potential downside (with a probability of 25%) may be that probable reserves become proved reserves at 70 units.

In the above example the expected value of the adjusted probable reserves would be:

$$(60\% * 100) + (15\% * 110) + (25\% * 70) = 93 \text{ units}$$

Accounting for Interests in Joint Ventures

40.

Many E&P enterprises enter into joint venture agreements for oil and gas exploration, development and production. In case of such arrangements, the accounting principles prescribed in Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint

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	Ventures', should be applied.
<u>Disposal of Interest</u>	
41.	<u>In case an enterprise sells a part of its interest in a cost centre, gain or loss should be recognised in the statement of profit and loss, except that no gain should be recognised at the time of such sale if substantial uncertainty exists about the recovery of the costs applicable to the retained interest or the enterprise has substantial obligation for future performance. The gain in such a situation (for example, in the exploratory phase) should be treated as recovery of cost related to that cost centre.</u>
<u>Accounting for side-tracking expenditure</u>	
42.	<u>Sometimes an E&P activity requires a second (or higher) attempt to drill a wellbore after the first wellbore has been junked (generally referred to 'side-track'). This saves re-drilling the top part of the hole but requires drop back to a smaller wellbore size in the sidetrack. In case of an exploratory well, the cost of abandoned portion should be treated in the same manner as the cost of dry well is considered in line with the method of accounting followed. The cost of side-tracking should be treated as the cost incurred on a new exploratory well.</u>
	<u>In case of development wells, the entire costs of abandoned portion and side-tracking should be capitalized.</u>
	<u>In case of producing wells, if the side-tacking results in additional proved developed oil and gas reserves, the cost incurred on side-tracking should be capitalized, whereas the cost of abandoned portion of the well due to side-tracking should be recognised as expense. In case there is no increase in the proved developed reserves due to side-tracking, the cost of side-tracking should be charged as expense and the cost of abandoned portion should be depleted in the normal way.</u>

Comment [K30]:
REASON FOR CHANGE:
Note 12:
 Inserted to include clarification on "Farm-out transactions".

Comment [K31]:
REASON FOR CHANGE:
Note 13:
 Proposed addition to cover the accounting for side-tracking costs is in line with EAC opinion.

CHANGES IN ACCOUNTING POLICIES*

43. (a) An enterprise may change the method of accounting from full cost method to successful efforts method. The change in the method of accounting should be carried out with retrospective effect. Such a change is treated as a change in accounting policy and should be accounted for in accordance with Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

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(b) When a change in the above method of accounting is made from full cost method to successful efforts method, the effect thereof is calculated in accordance with the new method as if the enterprise was always following the new method. The resulting deficiency/surplus should be charged/credited to the statement of profit and loss in the year in which the method of accounting is changed.

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44. However in specific circumstances, if an enterprise considers that the change from successful efforts method to full cost method would result in more appropriate presentation of its financial statements, it may change the method of accounting accordingly. The effect of the change in this case should only be applied prospectively. Accordingly, the expenditure which has already been recognized as expense in the profit or loss in the past should not be reversed.

DISCLOSURE

45. An E&P enterprise should disclose the following in its financial statements :

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i. The method of accounting followed.

* In case the treatment of accounting for changes in accounting policies is converged with IFRS with a consequential revision in AS 5, the treatment prescribed in paragraphs 43 and 44 would stand amended accordingly.

	ii.	Net quantities of an enterprise's interests in proved reserves and proved developed reserves of (a) oil (including condensate and natural gas liquids) and (b) gas as at the beginning and additions, deductions, production and closing balance for the year.
	iii.	Net quantities of an enterprise's interest in proved reserves and proved developed reserves of (a) oil and (b) gas should also be disclosed on the geographical basis.
	iv.	The reporting of reserve quantities should be stated in metric tonnes for oil reserves and cubic meters for gas reserves.
	v.	<u>Description and net quantities of an enterprise's interest of reserves used as a basis for impairment assessment.</u>
	vi.	<u>Frequency of reserve evaluation, principal assumptions used and involvement of any external expert(s).</u>
	vii.	<u>Classification of Oil and gas assets under tangible and intangible assets.</u> <u>Examples of intangible assets may include:</u> - <u>drilling rights and licences</u> - <u>acquired rights to explore</u> - <u>costs of surveys and studies, where capitalized</u> - <u>exploratory drilling costs.</u> <u>Examples of tangible assets may include:</u> - <u>equipment such as drilling rigs;</u> - <u>pipings, pumps, tanks;</u>

Comment [K32]:
REASON FOR CHANGE:
 In line with the concept of impairment proposed to be included

		- <u>vehicles.</u>
	<u>viii</u>	<u>Explanation of changes in reserve estimates.</u>

DRAFT

Appendix 1	
Glossary	
1.	Abandon To discontinue attempts to produce oil and gas from a mining lease area or a well and to plug the reservoir in accordance with regulatory requirements and salvage all recoverable equipments.
2.	Appraisal Well A well drilled as part of an appraisal drilling programme, which is carried out to determine the physical extent of oil and gas reserves and likely production rate of a field.
3.	Block A defined area for purposes of licensing or leasing to an enterprise or enterprises for exploration, development and production rights.
4.	Bottom-Hole Contributions Money or property paid to an operator for use in drilling a well on property in which the payer has no property interest. The contributions are payable when the well reaches a pre-determined depth, regardless of whether the well is productive or non-productive. The payer may receive proprietary information on the well's potential productivity.
5.	Condensate

	Low vapour pressure hydrocarbons obtained from Natural Gas through condensation or extraction and refer solely to those hydrocarbons that are liquid at normal surface temperature and pressure conditions.
6.	Dry Hole
	A well, which has proved to be non-productive.
7.	Dry Hole Contribution
	A contribution made by one enterprise to costs incurred by another enterprise that is drilling a nearby well to obtain information from the enterprise drilling the well; the contribution is made when the well is complete and is found to be unsuccessful.
8.	Geological and Geophysical Studies
	Processes which seek surface or subterranean indications of earth structure or formation where experience has shown the possibility of existence of mineral deposits.
9.	Geological Survey
	An exploratory programme directed to examination of rock and sediments obtained by boring or drilling, or by inspection of surface outcroppings.
10.	Geophysical Survey
	A study of the configuration of the earth's crust in a given area, as determined by the use of seismic, gravity, magnetic and geo-chemical procedures.
11.	Mining Lease

	The license issued for offshore and onshore properties for conducting development and production activity.
12.	Natural Gas Liquids (NGL) Hydrocarbons (primarily ethane, propane, butane and natural gasoline) which can be extracted from wet natural gas and become liquid under various combinations of increasing pressure and lower temperature.
13.	Petroleum Exploration License The license issued for offshore and onshore properties for conducting exploration activity.
14.	Support Equipment and Facilities Equipment and facilities of the nature of service units, camp facilities, godowns (for stores and spares), workshops (for equipment repairs), transport services (trucks and helicopters), catering facilities and drilling and seismic equipment.
15.	Work-Over Remedial work to the equipment within a well, the well pipework or relating to attempts to increase the rate of flow.

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Appendix 2

Arguments in favour of and against ‘successful efforts method’ and ‘full cost method’

<i>Arguments in favour of the Successful Efforts Method</i>	
1.	<i>Successful efforts costing reflects the normal concept of an asset.</i> An asset is an economic resource expected to provide future benefits. The ‘Framework for the Preparation and Presentation of Financial Statements’, in paragraph 49, defines an ‘asset’ as follows : "An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."
2.	Paragraphs 88 and 89 of the Framework reproduced below describe, respectively, when an asset is and is not to be recognised in the balance sheet : "88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably. 89. An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the enterprise beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the statement of profit and loss. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the enterprise or that management was misguided. The only implication is that the degree of certainty that economic

	benefits will flow to the enterprise beyond the current accounting period is insufficient to warrant the recognition of an asset."
3.	The Framework defines income (revenue) and expenses in terms of increases or decreases in assets and liabilities. The Framework does not provide for deferrals or accruals of costs or income based on an independently defined notion of profit or loss. Stated another way, the Framework does not provide for smoothing or normalising of earnings by deferring costs that do not meet the definition of an asset. Under the successful efforts method, those costs that clearly do not relate to future benefits are not capitalised.
4.	<i>The successful efforts method reflects the volatility that is inherent in exploring for oil and gas reserves. Those favouring successful efforts accounting argue that this method reflects the inherent risks and volatility that exist in the extractive industries because costs of unsuccessful efforts are charged to expense as they occur. They maintain that the capitalisation of unsuccessful exploratory efforts and their subsequent depreciation as unrelated reserves are produced would result in income smoothing that hides that volatility. Such capitalisation not only distorts the balance sheet by including as assets costs that have no future benefits, it also distorts the statement of profit and loss by deferring to future periods expenses that are incurred in the current period. Income smoothing results in the reporting of an artificial income both when the costs are deferred and throughout the periods of depreciation.</i>
5.	<i>The successful efforts method is consistent with the concept of matching according to which expenses are recognised in the statement of profit and loss on the basis of a direct association between the costs incurred and the earning of specific items of income. However, the application of the matching concept does not allow the recognition of items in the balance sheet, which do not meet the definition of assets and liabilities.</i>

6.	<i>Under the successful efforts method, the propriety of carrying forward costs incurred and subsequently matching them against future revenues depends on whether a specific cost can be identified with specific reserves. If this direct relationship does not exist, the cost should be charged to expense. If a direct association does not exist between a non-productive cost and reserves found and developed, the cost should not be classified as an asset because it is deemed to not provide future benefits in the form of cash flows. Charging non-productive costs to expense is consistent with the Framework - costs that do not result directly in future benefits are properly charged to expense. If costs related to unsuccessful ventures are not charged to expense, both current and future financial statements are distorted because those costs must eventually be removed from the balance sheet and reported in the statement of profit and loss even though they contribute nothing to future revenues.</i>
7.	<i>Successful efforts accounting comes closer than other cost-based accounting methods to reflecting management's successes or failures in its efforts to find new oil and gas reserves. If costs of unsuccessful exploration activities are capitalised rather than expensed, and carried forward and combined with costs incurred in prior years and with costs of the current year's successful activities, the efficiency and effectiveness of management is not evaluated in the statement of profit and loss because of the income smoothing that results. Under successful efforts accounting, this income smoothing is greatly reduced or eliminated.</i>
<i>Arguments against the Successful Efforts Method</i>	
8.	<i>Under the successful efforts method, the statement of profit and loss can give a false impression of performance in terms of success in finding new oil and gas reserves because of the effect of decisions to expand or curtail exploration expenditure. A reduction in exploration expense resulting from the curtailment of likely exploration would increase reported net profit</i>

Deleted: and development

	in the years in which the exploration is cut back, even though because of the cutback in exploration few or no new reserves are added. The cutback in reserve additions and the continuation of production results in a depletion of the enterprise's reserves, the source of its future profits and its long-run success. On the other hand, an enterprise with an outstanding exploration programme may increase its expenditures for exploration. This would almost certainly increase the current charges to expense for unsuccessful exploration efforts, reducing reported profit, even though the increased exploration may result in the addition of many new reserves that will produce future profits. Those who favour successful efforts accounting reply to this argument by observing that the goal of accounting is to reflect faithfully economic events. If management curtails exploration, this will be reflected in the financial statements under successful efforts accounting. Proponents of successful efforts accounting argue that perhaps, supplemental information about reserve quantities and value is needed to indicate success or failure of exploration activity.
9.	<i>Because of the charge-off of unsuccessful pre-production costs, successful efforts accounting often results in an understatement of assets and net income of a growing enterprise that has a successful and increasing exploration programme. In future years, when the exploration programme has stabilised or is actually decreasing, the deductions for unsuccessful projects will decrease or will become stable, resulting in higher reported net income. The understatement of income during the early years of the enterprise's activities may make it difficult to secure funds from either equity issues or borrowings.</i>
10.	<i>The successful efforts method assesses success or failure too early in a project. Success or failure of exploration projects usually cannot be measured until the exploration activities are completed, which may involve many years. In the intervening years, decisions must be made about costs to be charged to expense and costs to be capitalised. These decisions are often</i>

	subjective until the ultimate outcome is known, and different individuals will assess the same circumstances differently. This subjectivity from incomplete knowledge will result in different reported net income depending on the judgement of those making the assessment.
11.	The successful efforts method fails to recognise that in an E&P enterprise, management makes its plans and allocates resources to its search for new reserves on an enterprise-wide basis. The successful efforts method forces the costs of unsuccessful projects to be expensed even though they are an expected part of an exploration programme. The goal of exploration is to add new reserves and management knows that there will be failures in the process of attaining this goal. Management realises that costs of the failures must be offset by the results from successful ventures. Thus, they argue, costs of unsuccessful pre-production projects should be viewed as part of the cost of reserves obtained through successful exploration projects. Some argue that successful efforts accounting fails to recognise that all pre-production costs are incurred to find and develop whatever reserves result from pre-production activities.
<i>Arguments in favour of the Full Cost Method</i>	
12.	The full cost method reflects the way in which enterprises search for, acquire, and develop mineral resources. These activities are carried out in diverse locations, using various techniques and it is accepted that some projects will not result directly in the addition of reserves. However, it is planned that the value added by the successful ventures in a cost centre will be greater than the losses resulting from unsuccessful ventures in that cost centre and will result in an overall profit in the long term. Under the full cost method, all costs incurred at any time and at any place in a cost centre in an attempt to add commercial reserves are an essential part of the cost of any reserves added in that cost centre. As a result they are directly associated

	with the enterprise's reserves in that centre and all the costs should be treated as part of the cost of the mineral assets in the cost centre.
13.	<i>The full cost method provides better matching of income and expenses.</i> It is argued that there is a better matching of income and expenses if total costs are depreciated on a pro-rata basis as the total reserves in a large cost centre are produced than there would be if reserves and costs are matched in many small cost centres. In periods when an enterprise using successful efforts accounting incurs large pre-production expenditures in seeking new reserves, those costs that do not result in new reserves will be charged to expense, reducing profit and possibly resulting in a loss. The variability in profit resulting from changes in the expensing of pre-production costs are eliminated under the full cost method.
14.	<i>The full cost method is like absorption costing for manufactured inventories.</i> Oil and gas reserves are similar to a long-term inventory item. Generally, inventories are accounted for on an absorption cost basis. The costs related to unsuccessful efforts are very similar to normal recurring spoilage occurring in manufacturing operations. It is customary to treat normal spoilage costs as part of the cost of the good units manufactured.
15.	<i>The full cost method avoids distortions of reported earnings</i> Users of financial statements in the E&P industry are interested primarily in earnings and changes in earnings from year to year. It is argued that, if successful efforts accounting is used, distortions are caused by expensing unsuccessful efforts to find and develop new reserves, which may vary widely from year to year. Under the full cost method, these annual 'distortions' of income resulting from expensing the charges for unsuccessful pre-production activities are eliminated.
<i>Arguments against the Full Cost Method</i>	

16.	<i>Under the full cost method, many costs that are capitalised fail to meet the definition of ‘asset’ under the ‘Framework for the Preparation and Presentation of Financial Statements’.</i> Unsuccessful exploration costs, the costs of properties that contain no oil and gas reserves, and many other costs that will be capitalised are known to provide no future economic benefit. They will not contribute to the production of goods or services to be sold by the enterprise, they cannot be exchanged for other assets, they cannot be used to settle a liability, and they cannot be distributed to the owners of the enterprise. Further, Accounting Standard (AS) 2, ‘Valuation of Inventories’, requires that "abnormal amounts of wasted materials, labour, or other production costs" should be excluded from the cost of inventories and recognised as expenses in the period in which they are incurred (paragraph 13).	Comment [K33]: REASON FOR CHANGE: See note 5 above Deleted: prospecting costs, unsuccessful
17.	<i>The full cost method delays loss recognition.</i> Expenses should be reported on a timely basis. Costs that do not result directly in future benefits are costs that are properly charged to expense. Capitalising such costs results in deferring the effects of expenses.	
18.	<i>The full cost method impedes measurement of the efficiency and effectiveness of the enterprise’s exploration and development activities. Costs of unsuccessful activities are treated in the same way as successful activities and are matched against future revenues from all of the enterprise’s successful exploration and development activities. In any given year, management may conduct exploration and development activities that are completely unsuccessful, yet the statement of profit and loss would not reveal this fact.</i>	

PAGE 14: [3] Comment [K23]

REASON FOR CHANGE:

Note 9

Comment:

Conceptually, a write off is effected only where the expenditure incurred does not have any future economic benefit. In such a situation, if some more expenditure is incurred after the write off, as a consequence of which a resource comes into existence having future economic benefit, only the latter expenditure can be capitalised as per the existing generally accepted accounting principles. Accordingly, the expenditure in this regard which was written off earlier should not be reinstated subsequently.

- This is also in line with the principles of AS 26 in respect of research expenditure.
- Drawing analogy from AS 28 may not be appropriate since AS 28 requires recognition of impairment loss based on the estimated future cash flows and other factors and the same is reversed in case such estimations are changed. However, the expenditure on exploratory wells is written-off based on the event already occurred (say, declaration of dry well).