FASB STAFF POSITION

No. FAS 19-1

Title: Accounting for Suspended Well Costs

Date Posted: April 4, 2005

1. Questions have arisen as to whether there are circumstances that would permit the continued capitalization of exploratory well[1] costs beyond one year, other than when additional exploration wells are necessary to justify major capital expenditures and those wells are under way or firmly planned for the near future.

2. The Board directed the FASB staff to provide guidance on the accounting for exploratory well costs and to propose an amendment to FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, accordingly. The guidance in this FASB Staff Position (FSP) applies to enterprises that use the successful efforts method of accounting as described in Statement 19.

Background

3. Paragraph 19 of Statement 19 requires costs of drilling exploratory wells to be capitalized pending determination of whether the well has found proved reserves. If the well has found proved reserves, the capitalized costs become part of the enterprise's wells, equipment, and facilities; if, however, the well has not found proved reserves, the capitalized costs of drilling the well are expensed, net of any salvage value.

4. In certain circumstances, an exploratory well finds reserves but those reserves cannot be classified as proved when drilling is completed. To meet the classification of proved reserves, the geological and engineering data must support with reasonable certainty that the quantities of reserves are recoverable under *existing economic and operating conditions* (typically, prices and costs at the date that the estimate is made). For example, after reserves are found, an enterprise may be required to obtain additional geological information, government approvals, sales contracts, and project financing before the enterprise can classify the reserves as proved.

5. Paragraphs 31–34 of Statement 19 provide guidance on whether exploratory well costs can continue to be capitalized when the well finds reserves but those reserves cannot be classified as proved when drilling is completed. If reserves cannot be classified as proved in an area requiring a major capital expenditure, paragraphs 31(a) and 34 of Statement 19 require that the cost be carried as an asset provided that (a) there have been sufficient reserves found to justify completion as a producing well if the

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[1]Exploratory wells and exploratory-type stratigraphic wells, as defined in FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, are referred to collectively as exploratory wells for purposes of this FSP.

required capital expenditure is made, and (b) drilling of the additional exploratory wells is under way or firmly planned for the near future. If either of those two criteria is not met, the enterprise must expense the exploratory well costs.

6. For all other exploratory wells not addressed in paragraphs 31(a) and 34, paragraph 31(b) requires the capitalized costs to be expensed if the reserves cannot be classified as proved after one year following the completion of drilling.

7. Application of paragraphs 31 and 34 of Statement 19 to the facts and circumstances commonly faced by oil- and gas-producing companies in the current exploration and development environment has become a concern. For example, exploration activities are frequently performed in more remote areas, to greater depths, and in more complex geological formations than the exploration activities that occurred when the FASB issued Statement 19 in 1977. These changes in exploration activities have resulted in an increased frequency of exploratory wells that successfully find reserves that cannot be recognized as proved when drilling is completed and a lengthened evaluation period for determining whether the reserves qualify as proved. There are diverse views on how an enterprise should evaluate the criteria in paragraphs 31 and 34 in this changed environment—specifically, the one-year capitalization period.

FASB Staff Position

8. The FASB staff believes that exploratory well costs should continue to be capitalized when the well has found a sufficient quantity of reserves to justify its completion as a producing well and the enterprise is making sufficient progress assessing the reserves and the economic and operating viability of the project.[2]

Amendment to Statement 19

9. The Board has agreed to replace paragraphs 31–34 of Statement 19 with the following:

> ***Accounting When Drilling of an Exploratory Well or an Exploratory-type Stratigraphic Well Is Completed***
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> 31. As specified in paragraph 19, the costs of drilling an exploratory well or an exploratory-type stratigraphic well are capitalized as part of the enterprise's uncompleted wells, equipment, and facilities pending the determination of whether the well has found proved reserves. If proved reserves are found, the capitalized costs of drilling the well shall be reclassified as part of the costs of the enterprise's wells and related equipment and facilities at that time. If proved reserves are not found, the capitalized costs of drilling the well shall be charged to expense. However, an exploratory well or an exploratory-type stratigraphic well may be determined to have

[2] For purposes of this FSP, a project may include more than one exploratory well or exploratory-type stratigraphic well if the reserves are intended to be extracted in a single integrated producing operation (for example, the producing wells will operate with shared infrastructure).

found oil and gas reserves, but those reserves cannot be classified as proved when drilling is completed. In those cases, the capitalized drilling costs shall continue to be capitalized if the well has found a sufficient quantity of reserves to justify its completion as a producing well[2a] *and* the enterprise is making sufficient progress assessing the reserves and the economic and operating viability of the project.[2b] (Refer to paragraphs 32–34 for guidance on assessing whether an enterprise is making sufficient progress on assessing the reserves and the economic and operating viability of the project.)

31A. If either of those criteria is not met, or if an enterprise obtains information that raises substantial doubt about the economic or operational viability of the project, the exploratory well or exploratory-type stratigraphic well shall be assumed to be impaired and its costs, net of any salvage value, shall be charged to expense. Further, an enterprise shall not continue to capitalize exploratory well costs on the chance that (a) current market conditions will change (for example, an increase in the market price of oil or gas), or (b) technology will be developed to make the development of the project economically and operationally viable.

Progress on Assessing Reserves

32. All relevant facts and circumstances shall be evaluated when determining whether an enterprise is making sufficient progress on assessing the reserves and the economic and operating viability of the project. The following are some indicators, among others, that an enterprise is making sufficient progress. No single indicator is determinative. An entity should evaluate indicators in conjunction with all other relevant facts and circumstances.

a. Commitment of project personnel who are at the appropriate levels and who have the appropriate skills
b. Costs are being incurred to assess the reserves and their potential development
c. An assessment process covering the economic, legal, political, and environmental aspects of the potential development is in progress
d. Existence (or active negotiations) of sales contracts with customers for the oil and gas
e. Existence (or active negotiations) of agreements with governments, lenders, and venture partners
f. Outstanding requests for proposals for development of any required facilities
g. Existence of firm plans, established timetables, or contractual commitments, which may include seismic testing and drilling of additional exploratory wells
h. Progress is being made on contractual arrangements that will permit future development
i. Identification of existing transportation and other infrastructure that is or will be available for the project (subject to negotiations for use).

33. Long delays in the assessment or development plan (whether anticipated or unexpected) may raise doubts about whether the enterprise is making sufficient progress to continue the capitalization of exploratory well or exploratory-type

stratigraphic well costs after the completion of drilling. The longer the assessment process for the reserves and the project, the more difficult it is to conclude that the enterprise is making sufficient progress to continue the capitalization of those exploratory well or exploratory-type stratigraphic well costs.

34. If an enterprise has not engaged in substantial activities to assess the reserves or the development of the project in a reasonable period of time after the drilling of the well is completed or activities have been suspended, any capitalized costs associated with that well shall be expensed net of any salvage value. After a reasonable period of time, the planning of future activities without engaging in substantial activities is not sufficient to continue the capitalization of exploratory well or exploratory-type stratigraphic well costs. However, brief interruptions in activities required to assess the reserves or the project, or other delays resulting from governmental or other third-party evaluation of a proposed project, do not require capitalized exploratory well or exploratory-type stratigraphic well costs to be expensed.

[2a] To meet this criterion, an enterprise is not required to complete the exploratory or exploratory-type stratigraphic well as a producing well.

[2b] For purposes of determining whether capitalized drilling costs shall continue to be capitalized pending the determination of proved reserves, a project may include more than one exploratory well or exploratory-type stratigraphic well if the reserves are intended to be extracted in a single, integrated producing operation (for example, the producing wells will operate with shared infrastructure).

Disclosures

10. The objective of the disclosures required by this FSP is to provide users of financial statements with information about management's evaluation of capitalized exploratory well costs. The guidance in this FSP requires management to apply more judgment than was required by Statement 19 in evaluating whether the costs meet the criteria for continued capitalization. Accordingly, this FSP requires the following disclosures in the notes to the annual financial statements to provide information for users of financial statements about management's application of judgment in its evaluation of a project's capitalized exploratory well costs. These disclosures are not required routinely in interim financial statements; however, interim financial statements should include information about significant changes from the information presented in the most recent annual financial statements. Any impairment of capitalized exploratory well costs that were capitalized for a period of greater than one year after the completion of drilling at the most recent annual balance sheet date shall be considered significant for purposes of determining whether the change should be disclosed in interim financial statements.

a. An enterprise shall disclose the amount of capitalized exploratory well costs that is pending the determination of proved reserves. An enterprise also shall separately disclose for each annual period that an income statement is presented changes in those capitalized exploratory well costs resulting from (1) additions to capitalized exploratory well costs that are pending the determination of proved reserves, (2) capitalized exploratory well costs that were reclassified to wells, equipment, and facilities based on the determination of proved reserves, and (3) capitalized exploratory well costs that were charged to expense. This disclosure should not include amounts that were capitalized and subsequently expensed in the same annual period.

b. An enterprise shall disclose the amount of exploratory well costs that have been capitalized for a period of greater than one year after the completion of drilling at the most recent balance sheet date and the number of projects for which those costs relate. Additionally, for exploratory well costs that have been capitalized for periods greater than one year at the most recent balance sheet date, an enterprise shall provide an aging of those amounts by year, or by using a range of years, and the number of projects to which those costs relate.
c. For exploratory well costs that continue to be capitalized for more than one year after the completion of drilling at the most recent balance sheet date, an enterprise shall describe the projects and the activities that it has undertaken to date in order to evaluate the reserves and the projects, and the remaining activities required to classify the associated reserves as proved.

Effective Date and Transition

11. The guidance in this FSP shall be applied to the first reporting period beginning after April 4, 2005. The guidance should be applied prospectively to existing and newly capitalized exploratory well costs. Any capitalized exploratory well costs that are expensed upon the application of this guidance shall be recognized in income from continuing operations and either shall be presented as a separate component of operations or shall be disclosed in the notes to the financial statements. An enterprise shall quantify and describe the projects to which those costs relate. Capitalization of exploratory well costs that were previously expensed is not permitted. Early application of this guidance is permitted in periods for which financial statements have not yet been issued.

Disclosures for Transition and Periods Preceding the Adoption of This FSP

12. An enterprise shall provide the disclosures required by paragraphs 10(a)–10(c) of this FSP in the period of adoption, including an interim period. An enterprise also shall provide the disclosures required by paragraphs 10(a) and 10(b) of this FSP for annual periods preceding the adoption of this FSP. Those disclosures shall be provided in each prior period for which an income statement is presented and shall be presented based on the previous accounting method. An example follows.

Example Disclosures in the Year of Adoption

As of January 1, 2005, the Company adopted FASB Staff Position FAS 19-1, "Accounting for Suspended Well Costs." Upon adoption of the FSP, the Company evaluated all existing capitalized exploratory well costs under the provisions of the FSP. As a result, the Company determined that $175 of capitalized costs related to two separate projects was impaired and, therefore, the Company expensed those costs upon adoption of the FSP. (The Company also shall provide a description of those projects.) This expense is included in income from continuing operations. The following table reflects the net changes in capitalized exploratory well costs during 2005, 2004, and 2003, and does not include amounts that were capitalized and subsequently expensed in the same period. Capitalized exploratory well costs for fiscal years ending December 31, 2004, and December 31, 2003, are presented based on the Company's previous accounting policy.

	2005	2004	2003
Beginning balance at January 1	$ 975	$ 850	$ 800
Capitalized exploratory well costs charged to expense upon the adoption of FSP FAS 19-1	(175)	-	-
Additions to capitalized exploratory well costs pending the determination of proved reserves	375	500	350
Reclassifications to wells, facilities, and equipment based on the determination of proved reserves	(200)	(225)	(150)
Capitalized exploratory well costs charged to expense	(75)	(150)	(150)
Ending balance at December 31	$ 900	$ 975	$ 850

The following table provides an aging of capitalized exploratory well costs based on the date the drilling was completed and the number of projects for which exploratory well costs have been capitalized for a period greater than one year since the completion of drilling:

	2005	2004	2003
Capitalized exploratory well costs that have been capitalized for a period of one year or less	$ 375	$ 500	$ 350
Capitalized exploratory well costs that have been capitalized for a period greater than one year	525	475	500
Balance at December 31	$ 900	$ 975	$ 850
Number of projects that have exploratory well costs that have been capitalized for a period greater than one year	8	10	9

Included in the amount of exploratory well costs that have been capitalized for a period of greater than one year since the completion of drilling are costs of $45 and $95 that have been capitalized since 2001 and 2000, respectively, related to 2 projects. (The Company also shall provide the disclosures required by paragraph 10(c) of the FSP for those costs that at December 31, 2005, have been capitalized for a period of greater than one year following the completion of drilling.)