1994

Oil and gas producers industry developments - 1994; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Oil and Gas Producers Industry Developments—1994

Complement to AICPA Audit and Accounting Guide
Audits of Entities With Oil and Gas Producing Activities

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of oil and gas producers with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Industry and Economic Developments

Although the economy in general continued its upturn during 1994, the effects of recovery have yet to be felt by a number of oil and gas producers. On the whole, the general well-being of the oil and gas industry is influenced by factors such as Organization of Petroleum Exporting Countries (OPEC) politics, the volatility of crude oil prices, and the demand for natural gas more than by broad economic trends.

During 1994, the oil segment of the industry, in particular, continued to experience oversupply. World oil consumption, including that of the former Soviet Union, fell to 66.7 million barrels per day. Determined to maintain its market share, Saudi Arabia, the swing producer that sets the marginal price of crude oil, continued pumping out eight million barrels per day, 12 percent of the world's consumption. As a result, crude oil prices in the United States were very volatile during the year; the price rose to nearly $21 per barrel at one point and fell below $14 per barrel at another.

The short-term outlook for North American gas is currently brighter than that for oil largely due to a growing market. Technological advancements should help producers to recover more gas from existing reserves and also make new areas accessible. Auditors should be aware that producers may be involved in research and development (R&D) programs in attempts to take advantage of outstanding technological progress in this area. Guidance on R&D costs is provided by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 2, *Accounting for Research and Development Costs* (FASB, *Current Text*, vol. 1, sec. R50).

FASB Statement No. 2 requires that R&D costs be charged to expense as incurred. Examples of activities that typically would be included in R&D are outlined in FASB Statement No. 2, paragraph 9. In addition, FASB Statement No. 2, paragraph 10, cites examples of activities that typically would be excluded from R&D. Auditors of oil and gas producers should be familiar with the requirements of FASB Statement No. 2 and should review any costs that are deferred with the proper degree of professional skepticism.

Current prices and assumptions about future prices for crude oil and natural gas can have a significant effect on the amounts recorded in the

financial statements of oil and gas producers. Highly volatile or declining prices raise issues of liquidity, financing, asset realization, debt compliance, and going concern, all of which should be considered by auditors as they assess inherent risk in the industry.

The operating strategies being adopted by oil and gas producers to address economic factors such as these should also be carefully considered by auditors as they plan their audits. For example, certain oil and gas producers, in an attempt to strengthen their financial position, are reorganizing or restructuring their business operations. Still others are looking to technological advances to increase their efficiency and profitability. Such actions may have a significant effect on an entity's financial statements and should be carefully considered by auditors. These and other issues are addressed further in the "Audit Issues and Developments" section of this Audit Risk Alert.

Regulatory Developments

Minerals Management Service

In the oil and gas producers industry, the rights to drill wells and produce the minerals that are found are often obtained through leasing transactions, many of which involve federal or American-Indian land. Leases involving such land are administered by the Department of the Interior's Minerals Management Service (MMS). The MMS has always required, in its product valuation regulations, that royalties be paid on a value that cannot be less than the "gross proceeds" accruing to the lessee for the disposition of minerals produced from federal or American-Indian leases. During the past several years, many lessees have entered into agreements with purchasers settling various issues pertaining to the sale of production from federal and American-Indian leases that have arisen under their contracts. These settlements frequently involve a lump-sum payment by the purchaser, who is to be relieved of some or all of its obligations under the sales contract. MMS has issued a Royalty Management Program (RMP) interpretation of how the various gross proceeds regulations apply to amounts received under such contract settlements. The RMP interpretation clarifies that lessees and other debtors are required to pay royalties on contract settlement payments to the extent that payments are attributable to minerals produced from the lease. Under this interpretation, a number of settlements or all of a settlement may become royalty-bearing if production occurs to which specific money is attributable.

The MMS is continuing its efforts to recoup additional royalties related to take-or-pay settlements and price buydown agreements and

expects to collect, over the next few years, $200 to $300 million in royalties owed on these settlements. The agency is reviewing contract buyouts and contract buydowns that took place after natural gas prices plummeted. The agency has reviewed each of the following kinds of settlement and has issued the following conclusions:

1. Take-or-pay issues are not royalty-bearing.
2. Pure contract terminations are not royalty-bearing.
3. Past pricing disputes are not presumed to be royalty-bearing.
4. Recouped take-or-pay is presumed to be royalty-bearing.
5. At least some portion of a buydown is considered to be royalty-bearing.
6. Contract terminations for which no production is attributable are considered not to be royalty-bearing.

Auditors of oil and gas producers involved in these types of transactions should be aware of the preceding conclusions as they may represent unasserted claims. Auditors should follow the guidance contained in FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59). These contracts may need to be reviewed individually by the auditor, as most contracts differ and the issues are extremely complex. The auditor may wish to consider the use of a specialist in this area; if so, the auditor should follow the guidance of Statement on Auditing Standards (SAS) No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).

Federal Energy Regulatory Commission Order 636

The Federal Energy Regulatory Commission (FERC) Order 636 requires gas pipelines to "unbundle" their services from the traditional provision of gas services. Order 636 was issued in 1992 and was subsequently revised on rehearing by Orders 636-A and 636-B (collectively referred to herein as Order 636). Order 636 precipitated the complete transition to an open-access and competitive natural gas pipeline industry. Although Order 636 actually applies to the natural gas pipeline industry, it may indirectly affect natural gas producers as well. Such producers often enter into contracts to buy space on pipelines. Such contracts may result in commitments that producers should disclose in their financial statements. Auditors should consider the adequacy of disclosures of such commitments. Evidence that such disclosures are necessary may come to light as auditors review contracts between producers and pipeline owners.

Audit Issues and Developments

Overall Risk Factors

Although conditions vary from company to company, the following are among the conditions that may affect audit risk in the audits of financial statements of oil and gas producers.

Asset Realization. Auditors should address the collectibility of joint-interest receivables, the possible impairment of undeveloped properties resulting from declining leasehold values and the entity's inability to carry and develop properties, the potential impairment of producing properties as a result of the reduced value of the related reserves, and whether lease and well equipment inventory should be written down because of excess supply.

Product Marketability. The production of gas wells may be suspended because of excess supply or uncertainty about gas pricing. Auditors should consider whether nonproducing gas wells have been identified and should become aware of significant gas contract provisions and consider their potential impact on the financial statements.

Joint-Interest Operations. Joint ownership increases the likelihood of exposure to financially distressed operators. The auditor of a nonoperator may wish to consider the extent and findings of joint-interest audits, the adequacy of the operator's internal control structure, any conflicts of interest or related-party transactions involving the operator, and the operator's ability to meet its financial and operating commitments. Auditors may also consider whether the operator is using funds and properties in accordance with agreements and whether the nonoperator has legal and unencumbered ownership of properties and production revenues.

Reliability of Reserve Estimates. The reliability of reserve estimates depends primarily on the use of reputable and qualified petroleum engineers and on the availability, nature, completeness, and accuracy of the data needed to develop the reserve estimates. The reliability of reserve estimates has a direct impact on the calculation of depreciation, depletion, and amortization, as well as on "ceiling" or impairment tests.

Debt Compliance. Complying with debt covenants may be difficult for a number of oil and gas producers in an uncertain economic environment. Technical defaults require written waivers and close review by auditors. Auditors should refer to *Audit Risk Alert—1994* for a more detailed discussion of loan covenants.

Variety and Complexity of Agreements. The extensive use of innovative financing methods involving complex sharing and commitment terms that require accounting recognition or disclosure is common in the oil and gas producers industry. Complying with the specific terms of partnership, joint-venture, and operating agreements may be difficult. Certain standard contract terms (for example, dissolution, buyouts, and additional financing commitments) may take on increased importance for both the company and its auditors in an economic downturn. Auditors may wish to consider the use of a legal expert, under which circumstances the auditors should follow the guidance of SAS No. 73.

Complex Income Tax Considerations. The oil and gas producers industry is subject to very complex taxation, and as a result, income tax accruals of oil and gas companies are unusually complicated. Examples of tax matters unique to these industries are percentage depletion, tax credits for nonconventional fuel production, and tax credits for enhanced oil recovery. Virtually every oil and gas producer is faced with a variety of transactions that are treated differently for tax purposes than for financial reporting purposes. Furthermore, most independent oil and gas producers pay the alternative minimum tax (AMT) rather than the regular federal income tax, making the current expense portion of the income tax computation particularly complex. Auditors should have an understanding of the income tax considerations affecting the financial statements of oil and gas producers.

Hedging. From time to time, a number of oil and gas producers hedge or speculate with energy futures or options on such futures. Normally, subsequent production, rather than existing inventory, is hedged. FASB Statement No. 80, *Accounting for Futures Contracts* (FASB, *Current Text*, vol. 1, sec. F80), provides guidance on hedges of anticipated transactions.

Related-Party Transactions. Related-party transactions are often extensive; they may result in possible conflicts of interest among investors, operators, and general partners.

Environmental Matters

Environmental remediation issues continue to affect the oil and gas producers industry. Legislation such as the Oil Pollution Liability and Compensation Act of 1990 (the Act) and the Clean Air Act Amendments of 1990 address energy-related environmental problems in the United States. The principle behind such legislation is that, without government intervention, the prices of a number of energy products will not reflect the costs of environmental damage associated with their use.

Government actions such as taxes, restrictions, and prohibitions are intended to compensate for or prevent environmental harm and thereby internalize the costs of compensation or prevention into the prices paid by energy consumers. Among other things, higher prices due to internalized environmental costs increase the economic incentives to use cleaner, often renewable, fuels. The imposition of environmental standards through government regulation, although it involves little or no outlay of money by the government, can lead to very substantial increases in the cost of energy products.

Many of the new laws and regulations will affect the oil and gas producers industry. Nevertheless, the effects will usually be indirect because most of the new requirements will be imposed on vehicles, refineries, petroleum products, ships, and pipelines, as well as on the amount of pollutants, rather than directly on crude oil and natural gas producers.

The accounting literature applicable to accounting for environmental remediation liabilities includes the following:

- FASB Statement No. 5
- FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (FASB, *Current Text*, vol. 1, sec. C59)
- FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FASB, *Current Text*, vol. 1, sec. B10)

In addition, guidance is included in the consensus reached by the FASB's Emerging Issues Task Force (EITF) in the following:

- EITF Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination*
- EITF Issue No. 93-5, *Accounting for Environmental Liabilities*

In its discussion of EITF Issue No. 93-5, the EITF reached a consensus that an environmental liability should be evaluated independently from any potential claim for recovery (a two-event approach) and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization.

FASB Interpretation No. 39 discusses the appropriateness of offsetting assets and liabilities in the balance sheet and states that such an offset is improper unless a right of setoff exists. A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. The following conditions must be met in order for a right of setoff to exist:

- Each of the two parties owes the other determinable amounts.

- The reporting party has the right to set off the amount owed with the amount owed by the other party.
- The reporting party intends to set off.
- The right of setoff is enforceable by law.

The staff of the Securities and Exchange Commission (SEC) also has continued to articulate its views on the appropriate accounting and related disclosures for environmental remediation liabilities. In an effort to determine whether appropriate disclosure is made, the SEC staff receives from the United States Environmental Protection Agency (EPA) lists of all entities that have been designated as potentially responsible parties on Superfund sites, as well as information concerning entities subject to the cleanup requirements under the Resource Conservation and Recovery Act.

In June 1993, the SEC staff issued Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies*, which addresses issues related to loss contingencies, focusing primarily on environmental and product liability contingencies. SAB No. 92 provides the SEC staff's interpretation of current accounting literature related to matters such as the following:

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in the estimation of the extent of environmental liabilities
- The appropriate discount rate for environmental liabilities, if discounting is appropriate
- Financial statement disclosures of exit costs and other items, and the disclosure of certain information outside the basic financial statements

SAB No. 92 also addresses accounting and disclosure for site restoration or other environmental exit costs. Although industry practices with respect to exit costs may differ, SEC registrants must disclose their accounting policy for such costs pursuant to Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies* (FASB, *Current Text*, vol. 1, sec. A10). For material exit-cost liabilities, disclosures should include the nature of the costs involved, the total anticipated cost, the total costs accrued to date, the balance-sheet classification of accrued amounts, the range or amount of reasonably possible additional losses, and other related disclosures required by SAB No. 92.

SAB No. 92 also indicates that entities may accrue the exit costs over the useful life of an asset.

SAB No. 92 also indicates that if an entity is jointly and severally liable for a contaminated site but there is a reasonable basis for apportionment of costs among responsible parties, the entity need not recognize a liability for costs apportioned to other responsible parties. If, however, it is probable that other responsible parties will not fully pay the costs apportioned to them, the entity should include its best estimate, before consideration of potential recoveries from other parties, of the additional costs it expects to pay. A note to the financial statements should describe any additional loss that is reasonably possible. In addition, SAB No. 92 requires expanded disclosures of environmental and other contingencies and also provides disclosure and accounting guidance on site restoration and other exit costs.

Auditors should be alert to the possibility of an inappropriate delay in the accrual of an environmental loss until sufficient information is available to determine the best estimate of the liability. FASB Interpretation No. 14 requires entities to accrue a loss contingency when the estimated loss is within a range of amounts.

The applicable auditing guidance for environmental matters is found in the following:

- SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337)
- SAS No. 54, *Illegal Acts By Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317)
- SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342)
- SAS No. 73

Auditors should review the minutes of board of director meetings, regulatory reports, and other information related to environmental matters. Inquiry of both the entity's legal counsel and management responsible for environmental matters will provide auditors with useful information. Auditors should consider asking management whether the entity or any of its subsidiaries has been designated as a potentially responsible party by the EPA or otherwise has a high-risk exposure to environmental liabilities. If more than one potentially responsible party is associated with a contaminated site, each party may be contingently liable for the full amount of cleanup costs and fines because of the joint and several nature of environmental remediation laws. Such exposure could result in the need for an entity to accrue for cleanup costs or disclose a contingency and, possibly, necessitate the addition of an uncertainty paragraph in the auditor's report.

Audit Risk Alert—1994 contains further discussion on issues relating to environmental remediation matters.

Innovative Financing Arrangements

Over the past several years, there has been a slow deterioration in the domestic oil and gas producers industry and a move toward international expansion. As that trend continues, the availability of capital to fund oil and gas exploration remains tight. Much of the international expansion is being funded by redirecting operating cash flows away from domestic programs and into international programs. The more traditional flows of investment capital in the industry through direct investments, partnerships, and joint ventures with industry partners have all but disappeared. Much of the capital flowing into the industry is being supplied by insurance companies, international money banks, pension funds, and foreign investors.

Because of the high levels of risk and the significant capital requirements associated with oil and gas exploration, funds are raised and risks are shared by a wide variety of sophisticated and complex techniques. The more innovative methods of raising capital developed by the industry include completion funds, production purchase funds, mezzanine financing, oil field-services joint ventures, and exchange offers. The accounting for such arrangements or transactions is often not covered by or addressed specifically in existing authoritative literature. These arrangements or transactions may involve off-balance-sheet financing, special-purpose entities, and related questions about consolidation policies. Auditors should carefully evaluate such transactions as they assess the propriety of the related accounting treatment and financial statement disclosures.

Furthermore, changes in the natural gas markets have generated increased interest in production payments. Production payments are either payable in cash and expressed as a fixed sum of money payable from a specified share of production or payable in volumes and expressed as an obligation to deliver, free and clear of all expenses associated with the operation of the property, a specified quantity of gas (or oil) to the purchaser out of a specified share of future production. In accordance with FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies* (FASB, *Current Text*, vol. 2, sec. Oi5), production payments payable in cash are accounted for as borrowings and production payments payable in volumes are accounted for as unearned revenue because the seller has a substantial obligation for future performance. The seller of a volumetric production payment shall recognize revenue as the oil and gas is delivered. The purchaser has acquired an interest in an oil and gas property that

should be recorded at cost and amortized on a unit of production basis as delivery occurs. The oil and gas reserves production data, and standardized measure relating to the volumetric production payment quantities, shall be reported as those of the purchaser and not the seller.

Estimated Reserves

Reserve estimation is firmly rooted in science, yet the process relies heavily on past information and current engineering estimates to predict the future performance of oil and gas reservoirs. Reserve estimation is also heavily dependent on a number of subjective factors, as well as the experience of the estimator.

Reserve estimates have a direct effect on the calculation of depreciation, depletion, and amortization, as well as on "ceiling" or impairment tests. As a result, the reliability of reserve estimates is a key consideration in many aspects of accounting for oil and gas producing activities. In addition, a number of companies with bank debt and other forms of long-term borrowing may be subject to various debt covenants that are based on the value of oil and gas reserves. Such covenants may stipulate, for example, that if the value of the reserves falls below a certain level, the entire debt, or a part thereof, may be callable in the current year. As a result, the risk is generally high that imprecise reserve estimates will distort financial statements.

In assessing the reliability of reserve estimates, auditors should consider whether qualified and reputable petroleum engineers have been involved in determining reserve estimates. If engineers were involved in the determination of the reserve estimates, the auditor should follow the guidance in SAS No. 73.

Accordingly, auditors who use the work of a petroleum engineer in auditing the financial statements of an oil or gas producer should evaluate the professional qualifications of the specialist in determining that the specialist possesses the necessary skill or knowledge in the particular field. In making that evaluation, auditors should consider factors such as the following:

- The professional certification, license, or other recognition of the competence of the engineer in the field of petroleum engineering (The Society of Petroleum Engineers of the American Institute of Mining Engineers has established Standards Pertaining to the Estimating and Auditing of Oil and Gas Reserve Information. Those standards, which are included as appendix B to the AICPA Audit and Accounting Guide *Audits of Entities With Oil and Gas Producing Activities*, describe professional qualifications that should be met by reserve estimators and reserve auditors.)

- The reputation and standing of the engineer in the views of peers and others familiar with the specialist's capability or performance
- The engineer's experience in the type of work under consideration

Auditors who use the work of petroleum engineers in auditing the financial statements of oil and gas producers should also obtain an understanding of the nature of the work performed by the engineers. That understanding should cover the following:

- The objectives and scope of the engineer's work
- The engineer's relationship to the client
- The methods or assumptions used
- A comparison of the methods or assumptions used with those used in the preceding period
- The appropriateness of using the engineer's work for the intended purpose
- The form and content of the engineer's findings that will enable the auditor to evaluate the appropriateness and reasonableness of the methods and assumptions used and their application

Reporting on Required Supplementary Information

FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities* (FASB, *Current Text*, vol. 2, sec. Oi5), sets forth requirements for a comprehensive set of disclosures for oil and gas producing activities. The Statement also requires publicly traded enterprises with significant oil and gas producing activities to disclose prescribed supplementary information that includes data about their reserves. SAS No. 52, *Omnibus Statement on Auditing Standards—1987* (AICPA, *Professional Standards*, vol. 1, AU sec. 558, "Required Supplementary Information"), and Auditing Interpretation No. 1 of SAS No. 52, "Supplementary Oil and Gas Reserve Information," at AU section 9558.01–.06, provide guidance to auditors regarding the procedures that they should apply to required supplementary information and describe circumstances that require reporting on such information.

The auditors' objectives in applying procedures to the supplementary disclosures are to determine that—

1. The supplementary information prepared by the company is in conformity with the prescribed guidelines and is presented in a manner consistent with prior-year presentations.
2. Reserve quantity estimates are prepared by persons with appropriate qualifications.

3. The reserve information is consistent with the information in the underlying financial statements.

Research and Development

In attempting to increase their overall efficiency, a number of oil and gas producers are undertaking R&D programs that attempt to take advantage of technological advancements, particularly in the area of natural gas production. Auditors of oil and gas producers involved in such programs should consider whether these costs have been appropriately accounted for and disclosed. FASB Statement No. 2 requires that R&D costs be charged to expense when incurred. FASB Statement No. 2 also requires disclosure in the financial statements of the total R&D costs charged to expense in each period for which an income statement is presented.

Auditors of oil and gas producers should be particularly skeptical about any preproduction costs that are deferred. In such circumstances, they should carefully consider the adequacy of evidential matter available to substantiate the amount and propriety of the deferral, namely, that—

1. The development of the product to which the costs relate was complete as defined in FASB Statement No. 2.
2. The product was ready for production.

Investments in Derivatives

Recent years have seen a growing use of innovative financial instruments that often are very complex and can involve a substantial risk of loss. Oil and gas producers may hedge or speculate with energy futures or options on such futures. Normally, subsequent production rather than existing inventory is hedged. As interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments derive their value have increased in volatility over the past several months, a number of entities have incurred significant losses as a result of their use. The use of derivatives virtually always increases audit risk. Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, the auditors' approach to achieving related audit objectives may differ because certain derivatives are not generally recognized in the financial statements. Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1994.*

Related-Party Transactions

In the oil and gas producers industry, related-party transactions are often extensive; they may result in possible conflicts of interest among investors, operators, and general partners.

FASB Statement No. 57, *Related Party Disclosures* (FASB, *Current Text*, vol. 1, sec. R36), sets forth the requirements for related-party disclosures. Certain accounting pronouncements prescribe the accounting treatment if related parties are involved; however, established accounting principles ordinarily do not require transactions with related parties to be accounted for on a basis different from that which would be appropriate if the parties were not related. Auditors should view related-party transactions within the framework of existing pronouncements, placing emphasis on the adequacy of disclosure.

SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 334, "Related Parties"), provides guidance on procedures auditors should consider if they are performing an audit of financial statements in accordance with generally accepted auditing standards (GAAS) to identify related-party relationships and transactions. Auditors should satisfy themselves concerning the required financial statement accounting and disclosure.

Going Concern

In view of the sluggish state of the industry, auditors of oil and gas producers should continue to be alert to conditions that may indicate the existence of substantial doubt about the entity's ability to continue as a going concern. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), provides guidance to auditors in conducting audits of financial statements in accordance with GAAS for evaluating whether there is substantial doubt about the entity's ability to continue as a going concern.

As outlined in SAS No. 59, it is not necessary for auditors to design audit procedures solely to identify conditions and events that indicate that there could be substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited, as described in SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326). The following are examples of procedures that may identify such conditions and events:

- Analytical procedures
- Review of subsequent events
- Reading of minutes of meetings of stockholders, board of directors, and important committees of the board
- Inquiry of an entity's legal counsel about litigation, claims, and assessments
- Confirmation with related and third parties of the details of arrangements to provide or maintain financial support

If initial evaluation raises substantial doubt about the entity's ability to continue as a going concern, it may be necessary to obtain additional information about such conditions and events, as well as the appropriate information that mitigates the auditors' doubt. In such circumstances, the auditors should ask management about its plans for addressing the effects of the conditions or events underlying the going-concern question. The auditors should consider whether it is likely that the adverse effects will be mitigated by management's plans and whether those plans can be effectively implemented. Obtaining management's representations about its plans will not provide sufficient audit evidence to allay doubt about going-concern status.

If the auditors obtain sufficient evidence to alleviate their doubts in connection with the entity's going-concern status, the auditors should consider the need for financial statement disclosure of the principal conditions and events that initially caused the auditors to believe there was substantial doubt, and any mitigating factors, including management's plans. However, if the auditors consider identified conditions and events and management's plans, and conclude that substantial doubt remains about the entity's ability to continue as a going concern for a reasonable period of time, the audit report should include an explanatory paragraph to reflect that conclusion.

Using the Work of a Specialist

In July 1994, the AICPA's Auditing Standards Board issued SAS No. 73. SAS No. 73 supersedes SAS No. 11 of the same title and is effective for audits of financial statements for periods ending on or after December 15, 1994.

The new standard provides guidance for auditors who use the work of a specialist in audits of financial statements in accordance with GAAS. SAS No. 73 clarifies the applicability of guidance for using the work of a specialist. It also provides updated examples of situations that might require using the work of specialists, the types of specialists

being used today, and guidance to be followed if a specialist is related to the client.

SAS No. 73 applies whenever the auditor uses a specialist's work as evidential matter *in performing substantive tests* to evaluate material financial statement assertions, irrespective of any of the following:

- Management engages or employs the specialist.
- Management engages a specialist employed by the auditor's firm to provide advisory services.
- The auditor engages the specialist.

SAS No. 73 does not apply if a specialist employed by the auditor's firm participates in the audit. For example, if the auditor's firm employs a petroleum engineer and decides to use that petroleum engineer as part of the audit team to evaluate reserve estimates, SAS No. 73 would not apply. In such cases, the auditor should refer to SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311).

SAS No. 73 does not preclude the auditor from using a specialist who has a relationship with the client, including situations in which the client has the ability to directly or indirectly control or significantly influence the specialist. The standard does, however, require the auditor to evaluate the relationship and consider whether it might impair the specialist's objectivity. If the auditor concludes that the specialist's objectivity might be impaired, additional procedures should be performed, possibly including using the work of another specialist.

New Cost Centers

Many domestic oil and gas exploration and production companies using the full-cost method of accounting are involved in exploratory activities in foreign locations (new cost centers). In such circumstances, auditors should carefully evaluate the propriety of deferring costs for new cost centers if the outcome of a field, or concession as a whole, has not been determined. Auditors of publicly held registrants should note that rule 4-10(i)(3)(ii)(A) of SEC Regulation S-X states that any dry hole costs incurred should "be included in the amortization base immediately upon determination that the well is dry." Auditors should consider reviewing analyses of costs being deferred, as well as the results of the exploration activities in assessing the propriety of costs deferred. If results are favorable, an extended deferral may be appropriate; however, if results are unfavorable, continued deferral of the cost may not be justifiable.

Accounting Issues and Developments

Impairment of Oil and Gas Properties

Generally accepted accounting principles (GAAP) allow two acceptable methods of accounting for oil and gas assets: the full-cost method and the successful efforts method. Under the full-cost method, all acquisition, exploration, and development costs (including those associated with unsuccessful wells) are capitalized. Under the successful efforts method, the costs of unsuccessful (dry) exploration wells and certain other exploration costs are expensed.

Because most costs are capitalized under the full-cost method, SEC Regulation S-X, rule 4-10 requires that capitalized costs by publicly held companies following the full-cost method be subjected to a "ceiling test." Rule 4-10(i)(4) of Regulation S-X requires that for each cost center, capitalized costs, less accumulated amortization and related deferred-income taxes, shall not exceed an amount (the cost center ceiling) equal to the sum of the following:

1. The present value of future net revenues from proved reserves, computed using current prices and costs and a 10-percent annual discount factor, plus
2. The cost of properties not being amortized pursuant to paragraph (c)(3)(i) of rule 4-10(i)(4), plus
3. The lower of cost or estimated fair value of unproven properties included in the costs being amortized, less
4. Income-tax effects related to differences between the book and tax basis of the properties

The SEC staff has indicated that for entities using the successful efforts method of accounting for oil and gas properties, total capitalized costs, as a minimum test, may not exceed future undiscounted after-tax net revenues on a worldwide basis. Due to variations in the method for testing impairment for companies using the successful efforts method, the SEC staff has been requesting that registrants disclose their method for testing impairment.

The SEC staff also indicated a position that the ceiling test for full-cost companies and the worldwide impairment test for successful efforts companies should be applied using current prices at interim periods as well as at year end. [However, SAB 47 (Topic 12D) allows entities to consider the effects of price increases between the report date and date of issuance in mitigating the effects of a ceiling write-down otherwise called for.] The SEC staff has objected when registrants have used estimated annual prices in applying interim-period ceiling tests

because of the subjective nature of the process employed in estimating such prices.

In November 1993, the FASB issued an exposure draft of a proposed Statement entitled, *Accounting for the Impairment of Long-Lived Assets.* The proposed Statement addresses the accounting for the impairment of long-lived assets, as well as identifiable intangibles, and goodwill related to those assets. It would establish guidance for recognizing and measuring impairment losses and would require that the carrying amount of impaired assets be reduced to fair value.

If finalized under the same approach as proposed, the Statement would require that long-lived assets and identifiable intangibles held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. In performing the review for recoverability, entities would estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future net cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss would be recognized.

The measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use would be based on the fair value of the asset. Long-lived assets and identified intangibles to be disposed of would be reported at the lower of cost or fair value less cost to sell, except for assets that are covered by APB Opinion 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (FASB, *Current Text*, vol. 1, secs. I13, I17, and I22).

In estimating future cash flows for determining whether an asset is impaired, and if expected future net cash flows are used in measuring assets that are impaired, the proposed Statement will provide that assets shall be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets.

In addition, the exposure draft would impose specific grouping requirements in assessing impairment of the costs of an enterprise's wells and related equipment and facilities, and the costs of the related proved properties. The impairment provisions relating to unproved properties referred to in paragraphs 12, 27–39, 31(b), 33, 40, 47(g), and 47(h) of FASB Statement No. 19 would remain applicable to unproved properties.

However, at a meeting held on September 14, 1994 the FASB decided to revise the approach set forth in the exposure draft, thereby allowing

oil and gas producers subject to FASB Statement No. 19 to apply the general grouping requirements contained in the exposure draft. At this meeting, the FASB also decided not to address impairment issues for oil and gas enterprises using full-cost accounting.

Although a final Statement is expected by year end, it could be deferred. The exposure draft was proposed to be effective for financial statements issued for fiscal years beginning after December 15, 1994; the FASB has not decided on the effective date for any final statement.

Reserve Disclosures

FASB Statement No. 19, paragraph 47(a), for companies following the successful efforts method of accounting, and the SEC's Regulation S-X, rule 4-10(h)(5)(i), for companies following the full-cost method, require the seller to account for volumetric production payments received as unearned revenue to be recognized as the oil and gas are delivered. These rules also require that the related reserve estimates and production data be reported as those of the purchaser of the production payment and not of the seller in the disclosures required by FASB Statement No. 69. Auditors should carefully review reserve disclosures to ensure that sellers of volumetric production payments are properly excluding the related reserves from disclosures required by FASB Statement No. 69.

Financial Accounting Standards Board Statement on Derivatives

As previously discussed, oil and gas producers may use derivative financial instruments as risk management tools (hedges) or as speculative investment vehicles. These off-balance-sheet instruments are complex financial instruments whose values depend on the volatility of interest rates, foreign currency indices, and commodity and other prices.

In October 1994, the FASB issued Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). FASB Statement No. 119 requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25), and FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25).

FASB Statement No. 119 requires, among other things, disclosures about the amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. It also amends FASB Statement Nos. 105 and 107 to require that distinction in certain disclosures required by those statements.

For entities that hold or issue derivative financial instruments for trading purposes, FASB Statement No. 119 requires the disclosure of average fair value and of net trading gains or losses. For entities that hold or issue derivative financial instruments for purposes other than trading, it requires disclosure about those purposes and about how the instruments are reported in financial statements. For entities that hold or issue derivative financial instruments and account for them as hedges of anticipated transactions, it requires disclosure about the anticipated transactions, the classes of derivative financial instruments used to hedge those transactions, the amounts of hedging gains and losses deferred, and the transactions or other events that result in recognition of the deferred gains or losses in earnings. FASB Statement No. 119 also encourages, but does not require, quantitative information about market risks of derivative financial instruments, and also of other assets and liabilities, that is consistent with the way the entity manages or adjusts risks and that is useful for comparing the result of applying the entity's strategies to its objectives for holding or issuing the derivative financial instruments.

FASB Statement No. 119 amends FASB Statement No. 105 to require the disaggregation of information about financial instruments with off-balance-sheet risk of accounting loss by class, business activity, risk, or other category that is consistent with the entity's management of those instruments. FASB Statement No. 119 amends FASB Statement No. 107 to require that fair-value information be presented without combining, aggregating, or netting the fair value of derivative financial instruments with the fair value of nonderivative financial instruments. The information must be presented together with the related carrying amounts in the body of the financial statements, a single footnote, or a summary table in a form that makes it clear whether the amounts represent assets or liabilities.

Many oil and gas producers use futures, forwards, swaps, options, or other similar instruments in order to hedge future oil or gas prices (anticipatory hedges). The definition of a derivative financial instrument

in FASB Statement No. 119 excludes contracts that either require the exchange of a financial instrument for a nonfinancial commodity or permit the settlement of an obligation by delivery of a nonfinancial commodity because those contracts require or permit future exchange or delivery of an item that is not a financial instrument. Therefore, New York Mercantile Exchange futures contracts would not meet the definition of a derivative financial instrument because they permit settlement by physical delivery of oil or gas. However, price swaps or other financial instruments that can be settled only in cash or by delivery of another financial instrument would be covered by the disclosure requirements of FASB Statement No. 119.

FASB Statement No. 119 is effective for financial statements issued for fiscal years ending after December 15, 1994, except for entities with less than $150 million in total assets. For those entities, FASB Statement No. 119 is effective for financial statements issued for fiscal years ending after December 15, 1995.

Auditors of oil and gas producers that are parties to transactions that involve derivatives should be aware of the requirements of FASB Statement No. 119 and should consider whether the disclosures made by their clients in their financial statements are adequate and appropriate in view of the new requirements.

For companies with significant holdings of derivatives, which can or may be settled by delivery of a commodity, such as oil and gas, the SEC staff believes that SEC registrants should include disclosures regarding the nature and terms of such instruments in Management's Discussion and Analysis.

Restructurings

In attempts to ensure their future viability, many oil and gas producers have undertaken restructurings over the past few years. Among the actions associated with restructurings have been the termination of personnel, reduction in overhead by selling or leasing excess space, and elimination of specific product lines or divisions. The focus of the auditors' attention should be on the impact of reductions in personnel on operations and the internal control structure, and the reserve balances relating to current restructuring plans.

In evaluating the propriety of restructuring charges recorded by their clients, auditors should consider the consensus reached by the EITF on Issue No. 94-3, *Liability Recognition for Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, which provides guidance on whether certain costs (such as employee severance and termination costs) should be accrued and classified as part of restructuring charges, or whether such costs would be more appropriately

considered a recurring operating cost of the company. EITF Issue No. 94-3 provides guidance on the appropriate timing of recognition of restructuring charges and prescribes disclosures that should be included in the financial statements.

In addition, for publicly held oil and gas producers, SEC SAB No. 67 (Topic 5P), *Income Statement Presentation of Restructuring Charges,* describes restructuring charges as charges that "typically result from the consolidation and/or relocation of operations, the abandonment of operations or productive assets, or the impairment of the carrying value of productive or other long-lived assets." Restructuring charges have included costs such as employee benefits and severance costs, costs associated with the impairment or disposal of long-lived assets, facility closure costs, and other nonrecurring costs associated with the restructuring, and are required by SAB No. 67 (Topic 5P) to be included as a component of income from continuing operations. As a result of recent increases in the number of companies recording restructuring charges, the SEC has heightened its scrutiny of such charges.

AICPA Audit and Accounting Literature

Audit and Accounting Guide

The AICPA Audit and Accounting Guide *Audits of Entities With Oil and Gas Producing Activities* is available through the AICPA's loose-leaf subscription service. In the loose-leaf service, conforming changes (those necessitated by the issuance of new authoritative pronouncements) and other minor changes that do not require due process are incorporated periodically. Paperback editions of guides as they appear in the service are printed annually.

Oil and Gas Producers' Financial Reporting Checklist

The AICPA's Technical Information Service has published a revised version of *Checklist Supplement and Illustrative Financial Statements for Oil and Gas Producing Companies* as a tool for preparers and reviewers of financial statements of oil and gas producers. Copies can be obtained by calling the AICPA Order Department.

Technical Practice Aids

Technical Practice Aids is an AICPA publication that, among other things, contains questions received by the AICPA's Technical Information Service on various subjects and the service's responses to those questions. *Technical Practice Aids* contains questions and answers specifically

pertaining to oil and gas producing entities, and is available both as a subscription service and in hardcover form. Order information can be obtained from the AICPA Order Department.

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This Audit Risk Alert replaces *Oil and Gas Producers Industry Developments—1993.*

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Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1994* and *Compilation and Review Alert—1994,* which may be obtained by calling the AICPA Order Department at the number below and asking for product number 022141 (audit) or 060668 (compilation and review).

Copies of AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.