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Oil and Gas Producers Industry Developments—1995/96

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

American Institute of Certified Public Accountants

NOTICE TO READERS

This Audit Risk Alert is intended to provide auditors of financial statements of entities with oil and gas producing activities 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.

George Dietz
Technical Manager, Audit and Accounting Guides

Gerard L. Yarnall
Director, Audit and Accounting Guides

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Oil and Gas Producers Industry Developments—1995/96

Industry and Economic Developments

Oil and gas production includes those activities relating to the acquisition of mineral interests in properties, exploration and production (E&P), development, and production of crude oil, natural gas, and natural gas liquids (such as butane and propane).

Producers of oil and gas may be classified as independent or integrated companies. The so-called independents are those companies whose activities are typically limited to the exploration, development, and production of oil and gas properties. Integrated companies, on the other hand, are more diverse, with organizations involved not only in exploration, development, and production, but also in the operation of refineries, pipelines, and wholesale and retail outlets.

Surging demand for oil products in the United States resulted in strong prices during 1995. Led by high gasoline consumption during the summer driving season; favorable economic conditions; a steadily rising driver population, along with a de-emphasis on energy conservation, gasoline demand should, by year end, rise to its highest levels since 1978. Demand has also been strong for certain oil-based petrochemical products due to global economic growth and the increased use of synthetic chemical compounds by the textile and other industries. The demand for oil products from Pacific Rim countries has increased as well. And it is expected to continue, given that area's rising prosperity, increased automobile usage, and continued industrialization. In response, many of the largest domestic and foreign oil producers are repositioning their productive assets out of limited growth areas, such as the older, more mature markets of Europe and the United States, into areas of high-demand growth, such as the Pacific Rim.

The abnormally warm winter across much of North America drove down demand for natural gas. Increased drilling in the Gulf of Mexico and rising imports from Canada, along with the warm winter, kept gas inventories abundant. These supply and demand factors resulted in depressed natural gas prices through the first part of 1995. And, since gas prices are typically weakest during the summer months, there was no midyear price rally. The price of natural gas has showed no further declines, however, remaining moderately below prior-year levels. As

the heating season approaches, natural gas prices should rise modestly, but the abundance of supplies will likely preclude sustainable increases. Only an unusually cold winter can reduce those supplies to levels at which gas prices may rise to prior-year levels. If, on the other hand, the United States experiences another abnormally warm winter, the supply/demand factor will significantly lower gas prices. See further discussion of oil and natural gas prices under "Price Volatility" in the "Audit Issues" section of this Audit Risk Alert.

Along with product demand and seasonal requirements, production levels have a significant effect on the price of fossil fuels. In considering worldwide production levels, industry analysts always review the annual quotas set by the Organization of Petroleum Exporting Countries (OPEC). Although once the dominant force in oil production, OPEC is no longer the powerhouse it once was. At one time, OPEC was responsible for providing for 60 percent of the world's petroleum consumption—today, its share of the world market is down to less than 40 percent. As such, OPEC now finds itself competing for customers with prolific non-OPEC rivals in Asia, the North Sea, and Latin America, with most new demand for oil being met by sources outside of OPEC control. Still, OPEC plays a significant role in establishing worldwide production levels and, therefore, has a direct impact on oil prices. While OPEC has, in the past, attempted to gain market share by increasing production output this strategy has typically backfired by driving prices down due to excess supplies. OPEC is, therefore, unlikely to increase output for fear of the negative impact on revenues. Most industry analysts expect OPEC to maintain current oil production quotas through year-end.

The United States is the world's largest market for petroleum products. Although it is viewed as a mature market, recent expansion has occurred more rapidly than it has in some time. This should be good news for domestic producers except for the fact that the United States is importing more petroleum than ever before. Almost 52 percent of this year's domestic consumption was derived from foreign sources. Analysts predict that by the year 2000 imports will reach 65 percent. This trend to import has persisted over the past ten years; as a result, the domestic petroleum industry has been decimated. Daily domestic crude output has plummeted from more than 9 million barrels in the early 1980s to 6.5 million today. Hundreds of companies have gone bankrupt and more than 400,000 workers have been squeezed out of petroleum-related jobs. "Oil patch" lawmakers, deeply concerned about the premature abandonment of a significant number of wells, are vigorously pursuing tax breaks and regulatory relief for the struggling domestic industry and are adamant about trying to turn the tide on increasing foreign oil imports. While regulatory relief may be a reach-

able goal (see the "Legislative and Regulatory Issues" section of this Audit Risk Alert), tax breaks in the current budgetary climate are highly unlikely. Accordingly, despite strong oil prices, auditors should be aware that going-concern issues remain relevant in the current year. Auditors should consider their responsibilities pursuant to AICPA Statement on Auditing Standards (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). SAS No. 59 provides guidance to auditors for evaluating whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period not to exceed one year from the date of the financial statements being audited.

Merger and acquisition activity has increased during the current year in both the oil and gas segments of the industry. Most gas producers, feeling the continuing effects of deregulation (see the "Legislative and Regulatory Issues" section of this Audit Risk Alert), are buying their way into the more lucrative distribution business, though some others are diversifying through internal development. Depressed gas prices have driven some firms, with both high debt levels and a large stake in gas, to consider the option to merge. The increase in mergers and acquisitions among oil producers has generally been driven by firms burdened with high debt levels who are unable to develop promising fossil fuel properties. With limited access to outside financing, they have opted to merge with, or to be acquired by, cash-rich competitors. In these circumstances, auditors should consider whether management has appropriately accounted for transactions related to the merger or acquisition activities. Other audit implications of mergers and acquisitions are discussed in the "Accounting Issues and Developments" section of this Audit Risk Alert under "Restructuring Charges".

Oil and gas properties are the most significant assets of producers. The nonregenerative nature of these properties requires producers to engage in exploration activities to replenish their inventory of such wasting assets. However, domestic exploration has declined in part due to the enormous expense of recovering oil and gas from existing, mature reservoirs. In a move that many analysts believe will serve as a model for the industry, as it struggles to maintain a foothold in the nations's maturing oil fields, two major U.S. oil companies announced their intention to establish a jointly owned company to engage in domestic oil and gas exploration. Joint ventures of this type not only provide the financial resources necessary to employ the advanced oil recovery techniques crucial to the continued development of mature properties but also spread the significant risks over several participants. Joint ventures typically create redundancies which result in staff

reductions, streamlining operations, and other cost-cutting devices. The audit implications of such restructuring programs are discussed in the "Accounting Issues and Developments" section of this Audit Risk Alert.

Legislative and Regulatory Issues

Continuing Impact of FERC Order 636

The full effects of the radical changes brought about by Federal Energy Regulatory Commission (FERC) Orders 380, 436, 500, and particularly 636, are now being felt by the natural gas industry. With the intent of reversing federally granted monopolistic protection and enhancing competition among natural gas suppliers, the FERC Orders eliminated the advantage enjoyed by gas pipeline companies over other sellers of natural gas.

The advantages at issue are based on a pipeline company's ability to "bundle" gas, that is, its transportation and other related services, into a composite commodity. Given this, a pipeline's operating practices have tended to favor the transportation of its own product to the disadvantage of gas provided by other sellers that also is transported by the pipeline. The open access to transportation service granted by Order 636 has enabled buyers and sellers to go around the pipeline companies and deal directly with each other, thus resulting in a more efficient national market for natural gas. Rather than relying on pipeline companies to buy, store, and transport their gas, customers now have the option to deal with gas marketers that can put together gas supply packages tailored to the customer's specific needs.

The resulting economic circumstances of these regulatory changes mandate that the gas industry emphasize marketing. Most industry analysts believe those companies that do nothing else but produce gas will almost certainly be unprofitable. Thus, as gas producers are pressed to expand their operations into areas such as product marketing, auditors should be alert to the effects these new activities may have on the entity's internal control structure. Auditors should consider the implications on their assessment of control risk when such activities strain existing policies and procedures to the point where effectiveness may be reduced. In such circumstances, auditors should understand the control implications of expansion into new areas of operation, or the internal development of, for example, marketing operations. Documentation of that understanding is required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). If the assessment of control risk is high, auditors should adjust the scope of their

audits accordingly. If that understanding reveals significant deficiencies in the design or operation of the internal control structure, there is increased risk that material errors and irregularities will result in misstatements in the financial statements, and a reportable condition, as defined in SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), may exist.

Proposed Environmental Legislation

The new Congress has stated its intent to assess future environmental regulations from the perspective of required cost outlay to expected benefit. Without a demonstration that expected future costs are justified by expected future benefits, new regulations are unlikely to be issued. Given the significant costs of compliance, many oil and gas industry groups and trade associations have expressed their support for required analysis of cost-benefit assessments before the adoption of new regulations.

The Job Creation and Wage Enhancement Act (H.R. 9) follows through with the above-stated philosophy by rolling back certain federal regulations. Although the Senate may impose substantial modifications, the House bill is likely to set the tone for future environmental deregulation. The significant aspects of the Act propose—

- The temporary suspension of most new environmental regulation.
- The imposition of elaborate scientific review on proposed rules on health, safety, and environmental protection.
- Compensation for private landowners when environmental regulations reduce property values.

While these proposals provide insight into the possible future of environmental regulation, oil and gas producers currently face significant concerns with regard to remediation liabilities imposed by existing regulations. This issue is discussed further in the "Accounting Issues and Developments" section of this Audit Risk Alert.

Reformulated Gasoline Program

The federal government has in place a reformulated gasoline (RFG) program whose purpose is to ensure the availability of automobile fuel with less harmful environmental effects than conventional gasoline. While the impact of this program on crude oil and natural gas production is likely to be indirect, those integrated producers involved in refining activities are already feeling the effects on their operations. In

order to comply with these regulations, these entities are generally required to make additional investments to upgrade their facilities.

The program requires that the new gasoline be made available in certain geographical areas. However, other states and localities are permitted a certain degree of flexibility. They are allowed to "opt in" or "opt out" of the program. Therein lies the problem for refiners. For example, one company had already shipped the new reformulated gasoline to a number of Pennsylvania counties, which then chose not to participate in the program. Another company had modified its refining facilities in Kentucky to accommodate the production of RFG only to find out that the state is likely to back out of the program. Accordingly, integrated companies that have made the plant investments in their refineries necessary to produce reformulated gasoline may incur significant losses. Auditors should consider whether circumstances such as these call into question the recoverability of certain long-lived assets by integrated oil producers. See the "Accounting Issues and Developments" section of this Audit Risk Alert for further discussion of this issue.

Audit Issues

Price Volatility

As with most energy sources, fossil fuel prices generally track normal seasonal patterns. For example, gasoline prices can be expected to rise during peak summer driving months, while heating fuel prices will increase during the winter heating season. However, the prices of natural gas and oil products are difficult to predict with any degree of certainty. Due to the impact of such factors as worldwide production levels, economic growth rates, fluctuations in supply and demand, and unforeseen weather patterns, prices can be extremely volatile. A case in point was the threat, in October, of a massive hurricane in the Gulf of Mexico. In response to dire weather predictions, many major companies in the Gulf area implemented plans to curtail or completely shutter their operations. Analysts initially estimated that the storm would force producers to shut down 6.2 billion cubic feet of natural gas output, which is about 45 percent of total Gulf gas production, and 12 percent of total U.S. gas output. On the basis of these predictions, there was a surge of buying by traders, who viewed the impending weather conditions as a threat to offshore production facilities and coastal refineries. The impact on prices? Significant increases for both natural gas and crude oil. Natural gas scheduled for November delivery jumped $.144 to $1.894 per thousand cubic feet while crude prices increased by $.10 a barrel, settling at $17.64. Subsequent weather forecasts predicted

that the hurricane would bypass most offshore rigs. Ultimately, the storm lost strength and was downgraded from a hurricane to a tropical depression. Based on the revised weather report, along with rumors (later proved unfounded) of a one-time United Nations supervised sale of oil by Iraq, prices dropped to near twelve-month lows.

Price volatility presents considerable risks. Declines will produce obvious cash-flow problems. However, dramatic increases such as those described above may cause producers to overextend themselves. Liquidity problems may then arise when prices return to expected, or lower than expected, levels. Therefore, auditors may wish to consider the impact of price volatility on, for example, an oil and gas producer's—

- Debt-service requirements.
- Compliance with restrictive loan covenants.
- Valuations assigned to oil and gas reserves, especially those used as loan collateral.
- Cash flow for drilling commitments and trade payables.
- Ability to collect joint interest billings receivable.

Environmental Issues

In spite of the potential regulatory relief ahead, oil and gas producers face significant environmental compliance issues. Existing environmental remediation liability laws, written at all levels of government, have exposed entities with oil and gas producing activities to an increased vulnerability to environmental claims. Requirements imposed by federal, state, and local regulations that wells be plugged, all facilities and equipment removed, and terrain restored to specified conditions may expose producers to potential litigation. The Oil Pollution Liability and Compensation Act of 1990, the Superfund Amendments and Reauthorization Act, along with various clean air and water acts, may be used to hold oil and gas producers liable for the remediation of environmental contamination. Superfund, for example, legally empowers the U.S. Environmental Protection Agency to seek recovery from current and previous owners or operators of a particular contaminated site or from anyone who generated or transported hazardous substances to such a site.

Auditors should be aware that oil and gas producers may be held liable for cleanup costs despite their lack of intent or knowledge. Auditors of producers that face such claims should carefully consider whether the accounting and disclosure requirements of Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Con-*

tingencies (FASB, *Current Text,* vol. 1, sec. C59), have been met. FASB Statement No. 5 requires that an estimated loss be accrued when—

- Information available prior to the issuance of financial statements indicates that it is probable that an asset has been impaired or that a liability has been incurred at the date of the financial statements, and
- The amount of the loss can be reasonably estimated.

The nature and amount of the accrual should be disclosed if it is necessary for the financial statements not to be misleading. Additionally, other disclosures may be necessary when the above conditions are not met and, therefore, no loss has been accrued, or if the exposure to loss exceeds the amount accrued and the loss or additional loss is at least a reasonable possibility. In such circumstances, disclosures should include the nature of the contingency, an estimate of the possible loss or range of loss, or a statement that an estimate of the loss cannot be made.

Auditors should also be aware of the consensus reached by the FASB's Emerging Issues Task Force (EITF) in Issue No. 93-5, *Accounting for Environmental Liabilities,* which states that, among other things, an environmental liability should be evaluated independently from any potential recovery 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. Additional accounting guidance in this area is included in 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), EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal,* and EITF Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination.* See further discussion of this matter under the "Accounting Issues and Developments" section of this Audit Risk Alert.

Auditors of publicly held oil and gas producers should be aware of the Securities and Exchange Commission's (SEC's) Staff Accounting Bulletin (SAB) No. 92 (Topic 5-Y), *Accounting and Disclosures Relating to Loss Contingencies.* The SAB provides the SEC staff's interpretation of current accounting literature related to the following:

- The inappropriateness of offsetting probable recoveries against probable contingent liabilities
- The recognition of liabilities for costs apportioned to other potential responsible parties

- The uncertainties in estimating the extent of environmental liabilities
- The appropriate discount rate for environmental liabilities, if discounting is appropriate
- Accounting for exit costs
- Financial statement disclosures of exit costs and other items and disclosure of certain information outside the basic financial statements

Investments in Derivatives

In recent years there has been a growing use of innovative financial instruments, commonly referred to as derivatives, 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 obtain their value have increased in volatility, a number of entities have incurred significant losses as a result of their use. The use of derivatives almost 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.

It is essential that auditors understand both the economics of derivatives used by entities whose financial statements they audit and the nature and business purpose of the entities' derivatives activities. In addition, auditors should carefully evaluate their clients' accounting for any such instruments, especially those carried at other than market value. To the extent the derivatives qualify as financial instruments as defined in FASB Statements 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), No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25), the disclosure requirements set forth in those Statements must be met. When derivatives are accounted for as hedges of on-balance-sheet assets or liabilities or of anticipated transactions, auditors should carefully review the appropriateness of the use of

hedge accounting, particularly considering whether the criteria set forth in applicable accounting literature are met.

The SEC staff has indicated in public speeches and letters of comment to registrants during the past year that publicly held companies should disclose the nature and purpose of certain commodity-based derivatives activities, the nature and terms of certain commodity-based derivatives used, and the accounting methods used even when such derivatives do not meet the definition of financial instruments set forth in the FASB Statements cited above.

Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1995/96*. Also, see "Disclosures About Derivatives" in the "Accounting Issues and Developments" section of this Audit Risk Alert. The AICPA publication *Derivatives-Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations.

Related-Party Transactions

In the oil and gas production industry, related-party transactions are often extensive and may result in possible conflicts of interest among investors, operators, and general partners. Though always an area of significant audit risk, related-party concerns are particularly important in the current year given the rise in joint ventures brought about by regulatory forces affecting gas producers and economic necessity in the case of some oil producers.

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*, "Related Parties" (AICPA, *Professional Standards*, vol. 1, AU sec. 334), provides guidance on procedures auditors should consider if they are performing an audit of financial statements in accordance with generally accepted auditing standards to identify related-party relationships and transactions. Auditors should satisfy themselves concerning the required financial statement accounting and disclosure.

Estimated Reserves

The reliability of reserve estimates is a key consideration in many aspects of accounting for oil and gas producing activities. This area could be a source of significant audit risk in the current year as domestic producers apply advanced, unproven recovery techniques to mature reservoirs. Reserve estimates have a direct impact on the calculation of depreciation, depletion, and amortization as well as on ceiling and impairment tests. In addition, some 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. Auditors should review debt covenants for such matters and consider the effect of reserve valuations and debt restrictions. Auditors should be alert to matters subject to "events of default" and, if necessary, examine written waivers from lending institutions.

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, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).

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 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; and 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.

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*, "Required Supplementary Information" (AICPA, *Professional Standards*, vol. 1, AU sec. 558), provides guidance to auditors regarding the procedures they should apply to required supplementary information and describes circumstances that require reporting on such information.

Adequacy of Disclosure

SAS No. 32, *Adequacy of Disclosure in Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 431), sets forth the auditor's responsibility to ensure that audited financial statements include disclosures required by generally accepted accounting principles. SEC staff has noted several instances in which financial statement disclosures have been inadequate. For example—

- Standardized Measure of Discounted Future Net Cash Flows. FASB Statement No. 69 requires the disclosure of both future net cash flows and the standardized measure of discounted future cash flows in the aggregate and for each geographic area for which reserve quantities are disclosed. In the financial statements of publicly held entities, the SEC staff has noted presentations of the required supplementary information on the standardized measure of discounted future cash flows that omit the line item "future net cash flows". Such presentations fail to comply with the specific disclosure requirements of Statement No. 69, paragraph 30(d). Illustration 5 in appendix A to Statement No. 69 provides an example of the disclosures required to comply with paragraph 30 of that Statement.

- Volumetric Production Payments. FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies* (FASB, *Current Text,* vol. 2, sec. Oi5), paragraph 47(a), for companies following the successful efforts method of accounting, and Rule 4-10(h)(5)(i) of SEC Regulation S-X, 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 is 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 are properly excluding the related reserves from the disclosures required by FASB Statement No. 69.

Accounting Issues and Developments

Impairment of Long-Lived Assets

In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text,* vol. 1, sec. I08). FASB Statement No. 121 establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, and for long-lived assets and certain identifiable intangibles to be disposed of. The Statement requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, the Statement requires that the entity 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 cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. (The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties.)

The Statement also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets covered by Accounting Principles Board (APB) Opinion No. 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, sec. I13). Assets covered by APB Opinion No. 30 will continue to be reported at the lower of the carrying amount or the net realizable value.

The Statement is effective for financial statements for fiscal years beginning after December 15, 1995. Restatement of previously issued financial statements is not permitted by the Statement. The Statement requires that impairment losses resulting from its application be reported in the period in which the recognition criteria are first applied and met. The Statement requires that initial application of its provisions to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

The Statement (paragraph 25) also amends FASB Statement No. 19 by adding a new paragraph dealing with impairment test for proved properties and capitalized exploration and development cost after paragraph 62. The paragraph reads as follows:

> The provisions of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* are applicable to 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, 27-29, 31(b), 33, 40, 47(g), and 47(h) of this Statement remain applicable to unproved properties.

Given the capital-intensive nature of oil and gas production activities, auditors should be alert to those events or changes in circumstances that indicate an impairment of an asset may have occurred. For example, auditors should consider the possible impairment of—

- Undeveloped properties—resulting from declining leasehold values.
- Producing properties—as a result of the reduced value of the related reserves.
- Lease and well equipment inventory—due to excess supply.

Auditors of integrated oil producers should consider the possible impairment of—

- Plant investments necessary to produce reformulated gasoline for refineries located in areas that have opted out of the RFG program.

- Single-hulled tankers and barges required to be phased out over a fifteen-year period pursuant to the Oil Pollution and Liability Compensation Act of 1990.

As oil and gas producers adopt technologically advanced recovery techniques for mature properties, traditional long-lived equipment may be rendered obsolete. Additionally, environmental regulations may impose restrictions on the use of a long-lived asset used in exploration, development, and production, thus significantly reducing its ability to generate future cash flows. In these instances, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121 may need to be applied.

In considering an oil and gas production entity's implementation of FASB Statement No. 121, auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. Management's estimates of future cash flows from asset use and impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342).

In the past, the SEC staff has, as a matter of administrative policy, required publicly held entities that use the successful efforts method of accounting, to recognize an impairment loss on oil and gas properties when the total capitalized costs of such properties exceed undiscounted after tax net revenues on a worldwide basis. Such an impairment policy represented only a minimum test for impairment; successful efforts entities could elect to apply a more "stringent" test for impairment. The SEC staff has indicated in public speeches during the past several months that upon the adoption of FASB Statement No. 121, publicly held entities using the successful efforts method of accounting will be required to comply with the provisions of the new impairment standards rather than follow the previous minimum standard.

Risks and Uncertainties

In December 1994, the AICPA's Accounting Standards Executive Committee issued Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* SOP 94-6 requires nongovernmental entities to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of financial statements. In addition, if specified criteria are met, SOP 94-6 requires organizations to include in their financial

statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to changes in the near term. Examples of similar estimates that may be included in the financial statements of oil and gas producers include, but are not limited to the following:

- Estimates of oil and gas reserve quantities
- Standardized measure of discounted future net cash flows relating to proved oil and gas reserve quantities

Examples of concentrations that may meet the criteria that require disclosure in the financial statements of oil and gas producers in accordance with paragraph 21 of the SOP include the following:

- Revenue from a particular oil or gas based product
- Exploration, development, and production of properties in a particular geographic area
- International exploration activities

The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which SOP 94-6 is first applied.

Auditors should be alert to the requirements of the new SOP and its impact on the financial statements they audit. Auditors should carefully consider whether all significant estimates and concentrations have been identified and considered for disclosure.

Restructuring Charges

Oil and gas producers have seen an increased rate of mergers, acquisitions, and related activities. These entities typically seek to gain access to new markets through acquisition or to concentrate on their core business by divesting themselves of unrelated divisions. Greater cost efficiencies and economies of scale are being sought through such vertical and horizontal integrations. For example, during the current year:

- Two major U.S. oil companies announced their intention to establish a jointly owned company to engage in oil and gas exploration and production.

- Declining U.S. oil production has prompted domestic producers to seek overseas opportunities. As part of that reallocation of assets, many producers have been downsizing their domestic operations and selling off marginal production properties.
- In a billion dollar sale, one major oil producer shed its plastics division to concentrate on its core operations—oil, gas, and petrochemicals. (Authoritative guidance on accounting for the disposal of a business segment is set forth in APB Opinion No. 30.)

The restructuring that often accompanies these activities typically creates redundancies that raise the specter of staff reductions and related cost-cutting measures as duplicate functions are eliminated and existing areas streamlined. Auditors should consider the impact of such activities on the entity's operations and internal control structure; the reserves relating to current restructuring plans; and the appropriate period for reporting the costs associated with restructurings.

In considering restructuring liabilities and costs, auditors should be aware of EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, for authoritative guidance on the appropriate accounting for restructurings. EITF Issue No. 94-3 also provides guidance on (1) the types of costs that should be accrued, (2) the timing of recognition of restructuring charges, and (3) prescriptions for disclosures that should be included in the financial statements.

For publicly held entities, SEC SAB No. 67 (Topic 5P), *Income Statement Presentation of Restructuring Charges*, requires that restructuring charges be reported as a component of income from continuing operations.

Disclosures About Derivatives

As previously discussed, oil and gas producers may employ derivative financial instruments as risk management tools. Derivatives are complex financial instruments whose values are affected by the volatility of interest rates, foreign currency indices, and commodity and other prices.

In October 1994, the FASB issued Statement No. 119 which 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 Statements No. 105 and No. 107.

FASB Statement No. 119 requires disclosures about 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. Paragraph 12 of FASB Statement No. 119 encourages, but does not require, entities to disclose quantitative information about risks associated with derivatives.

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

The FASB Special Report *Illustrations of Financial Instrument Disclosures* contains illustrations of the application of FASB Statements No. 105, No. 107, and No. 119.

AICPA Exposure Draft: Proposed Statement of Position on Environmental Remediation Liabilities

Environmental compliance costs may be significant for oil and gas producers. Federal, state, and local regulations require that depleted well sites be plugged, facilities and equipment removed, and the terrain restored to specified conditions. As such, auditors should note that in June 1995, the AICPA issued an exposure draft of a proposed SOP, *Environmental Remediation Liabilities*. The exposure draft provides that:

- Environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 are met: the exposure draft includes benchmarks to aid in determining when those criteria are met.
- Accruals for environmental remediation liabilities should include (1) incremental direct costs of the remediation effort, as defined, and (2) costs of compensation and benefits for employees to the extent the employees are expected to devote time to the remediation effort.
- Measurement of the liabilities should include (1) the entity's specific share of the liability for a specific site and (2) the entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.

- Measurement of the liability should be based on enacted laws and existing regulations, policies, and remediation technology.
- Measurement should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed and may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments for a site are fixed or reliably determinable.

The exposure draft also includes guidance on display in the financial statements of environmental remediation liabilities and on disclosures about environmental cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations. A separate, nonauthoritative section of the exposure draft discusses major federal environmental pollution responsibility and clean up laws and the need to consider various individual state and other non-U.S. government requirements.

Disclosures—Publicly Held Companies

Management's Discussion and Analysis. SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 550), requires that auditors read such information and consider whether it and the manner of its presentation are materially consistent with information appearing in the financial statements. As auditors of oil and gas producers that are required to file reports with the SEC read the Management's Discussion and Analysis (MD&A) sections of SEC filings, they might consider whether the MD&A includes discussions of—

- The impact of recently issued accounting standards that are not effective until some future date. If the adoption of a standard is expected to have a significant effect on the oil and gas producer's financial position or results of operations, the MD&A disclosure should (1) notify that a standard has been issued which the oil and gas producer will be required to adopt in the future and (2) assess the significance of the impact the adoption of the standard should have on the company's financial statements (unless this cannot be reasonably estimated, in which case a statement to that effect should be made).
- The effects of hedging on liquidity and results of operations.

- Known trends, demands, commitments, events, or uncertainties that are reasonably likely to have a material effect on the oil and gas producer's results of operations or financial condition.

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 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 the Guides as they appear in the service are printed annually.

Information Sources

Further information on matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

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This Audit Risk Alert supersedes *Oil and Gas Producers Industry Developments—1994.*

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Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1995/96* and *Compilation and Review Alert—1995/96,* which may be obtained by calling the AICPA Order Department and asking for product number 022180 (audit) or 060669 (compilation and review).

Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants (AICPA)	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department (800) 862-4272	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board (FASB)	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10 Action Alert Telephone Line (203) 847-0700, ext. 444 Copies of FASB publications referred to in this document may be obtained directly from the FASB by calling the FASB Order Department.			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. Securities and Exchange Commission (SEC)	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 4 (202) 942-7114 (tty)		*Information Line* (202) 942-8088 (202) 942-7114 (tty)

Institute of Petroleum Accounting	University of North Texas P.O. Box 13677 Denton, Texas 76203-6677	*General Information* (817) 565-3170 Fax (817) 369-8839		
American Petroleum Institute	1220 L Street NW Washington, DC 20005 Publications and Materials (202) 682-8000	*General Information* (202) 783-9000		
Gas Research Institute	8600 W. Bryn Mawr Chicago, IL 60631	*General Information* (312) 399-8100		

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