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Accounting Questions: Overhead Expenses of an Oil Company, Hospital Operating Costs

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Accounting Questions

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OVERHEAD EXPENSES OF AN OIL COMPANY

Question: Will you please secure an authoritative opinion as to the better accounting practice for overhead expenses of an oil company in the following situation?

A corporation is formed to engage in a general oil business but is confining its activities primarily to exploring for and acquiring potential oil-bearing lands in the gulf-coast region of Texas and Louisiana. Inasmuch as production in this area is found on or about salt domes, which, in the main, can only be discovered by geophysical means, the company has its own geophysical staff and working crews.

During the latter half of 1933 and up to October, 1934, the geophysical group surveyed approximately 480,000 acres of land and thereafter, out of all the acreage surveyed, decided to lease or develop approximately 15,000 acres in several localities which the result of the geophysical work indicated to be apt to produce oil.

Inasmuch as, during the period from 1933 to 1934, the company's entire activities were centered in geophysical exploration work and practically all expenditures were made in furtherance of this work, the directors instructed the auditor, in preparing the financial statement of the company for the year ended December 31, 1934, to charge the above-mentioned geophysical and overhead expenses to the cost of property acquired, as follows:

Exploration, field and geophysical expenses

Exploration expenses	$13,410
Field and geophysical expenses	1,277
Repairs and depreciation of field equipment	1,719
Insurance of field equipment	675
Legal expenses, covering title examination and preparation of contracts	2,479

Telephone and telegraph—mostly between New York directors and Texas field offices, regarding acquisition of properties and progress of work	$2,058
Salaries and wages of geophysicists and field personnel—approximately	20,000
Traveling and automobile expenses—covering, mostly, field examinations	11,600
Office and general expenses	10,996
Grand total	$64,214
The direct lease costs, for acquiring the above-mentioned property, were—approximately	32,000
Making a total property cost of	$96,214

Because of the nature of the work, as above explained, and the large area to be examined before eventually determining the favorable properties, the overhead expense must, necessarily, represent the largest part of the cost. This overhead expense is prorated over the various properties to be developed, on the basis of the direct cost of each property.

Answer No. 1: The question seems to divide itself into two parts. First, the general distribution of the expenses and, second, their application to individual units of property or production.

I think there is no doubt that in any extractive industry—mining, lumbering, quarrying or the oil industry—any expenditures made previous to the extraction in paying quantities of the mineral under development is a charge to the cost of the property. In some cases it may be desirable to distinguish between cost of property, general development work and development work applying to specific units, all of which may be extinguished at varying rates. The application of this principle may be complex, but the principle itself is clear, that is, that no money can be gained or lost before the commercial extraction of the mineral has begun. It is also clear from this that any mineral extracted incidentally to the exploration and development work before extraction on a commercial scale is merely a credit to development expense and not income. The fact that some or even a substantial portion of the development work is done on properties later discovered to be valueless does not change the fact that the aggregate cost of exploration and development is the cost of the properties finally put into production.

The foregoing applies particularly to a new enterprise. It is, of course, obvious in an established enterprise that a certain amount of exploration and development work goes on all the time and should be charged off currently. In an established enterprise, any suggestion to defer large items for development and exploration should be examined carefully and the utmost caution exercised in permitting the capitalization or deferring of such expenditures. The present question, however, I understand, deals with a new enterprise previous to entering into production.

The second question, that is, distribution to individual units, depends largely on the intentions of the owners of the property. If it is intended to break up the property into small lots and sell them as individual properties or as lease or royalty participations, there is then some warrant for distributing the development cost on a basis of acreage. This is not strictly accurate, as the purposes for which the development expenditures were made was the production of oil, not the acquisition of real estate. However, if it is the intention to sell the property, it is to a certain extent comparable to a real-estate development and this method will probably be as satisfactory as any that can be devised.

If the property is to be operated by the owners after coming into production, it would seem preferable to determine as nearly as possible the minimum content of oil in the developed properties and to write off the development on a basis of the quantity of oil produced. The minimum content should be estimated quite conservatively so as to assure the extinguishment of the development expense over a comparatively short time as there would be no great disadvantage in writing the development off previous to the exhaustion of the property.

The question as to whether it would be advisable to write off development pro rata with the depletion allowed by the United States treasury department should be considered. On the whole, if acceptable to the department, it would appear better to write development off over a shorter period. This, however, is a question which must be considered on the merits of each individual case.

The foregoing is, of course, general and applies more to the financial accounting of the company than to the tax problem. There is not enough information given to make any attempt to advise as to the company's attitude on federal taxes.

Answer No. 2: I should apportion the exploration expenses, amounting to $64,214, over the leaseholds acquired, on an acreage basis, about $4.28 per acre. Rather than to create a reserve before commencement of operation, field equipment should be appraised and the investment credited direct with the amount to be included in apportionable exploration expenses. These expenses should be carried in a sub-account of each lease entitled "exploration costs."

Having capitalized the exploration expenses, obviously, they are returnable, in this case, through reserve for depletion; and the company, for the sake of consistency, is committed to that practice in subsequent years. Ordinarily, expenses of this nature are deductible 100% in the year in which they are incurred.

HOSPITAL OPERATING COSTS

Question: A client of ours, interested in a hospital in his locality, has requested that we furnish him with certain statistical information relating to hospital operating costs. This particular hospital is in a city of about 10,000 inhabitants and serves the city and surrounding community. The directors are anxious to know how their costs compare with those of other hospitals situated in approximately the same position.

The local chamber of commerce is interested in the matter and the secretary of that body has suggested the following statistical information:

"Basic cost per patient per day to include operating and administrative expense such as light, heat, water, taxes, if any; insurance, nurse hire, food and all wages charged to administration.

"This basic cost item should be found by a detailed study of the books of the institution, over a period of several years if necessary.

"Basic cost per patient per day should be in two groups, pay patients and pauper patients.

"Under basic cost should appear average cost of extras, such as operating room, anæsthetics, dressings, etc.—also cost of special nurses per day."

This institution is operated on a non-profitable basis, that is, no profit accrues to any individual member of the association. It receives subsidy from the local city and county governments.

Answer: Practically every hospital of any size or importance covers in its accounting information all of the statistical information you have enumerated in the four paragraphs of your letter. Not all hospitals, however, discriminate in this cost between pay patients and pauper patients. For instance, there is no greater and no less expense, regardless of the pay or non-pay status of the patient, so far as the cost to the hospital in furnishing the operating room conveniences, the linens, the nursing and other service for an operation, the amount of anæsthetic consumed, or the bandages used, or any other of the material that is expended or labor that is bestowed upon the patient while in the operating room and during the period of his treatment after operation. Food costs for patients in the hospital do not vary materially, if at all, as applied to the pay patient or the pauper patient. Two eggs served as a part of the meal for the pay patient will cost just as much as two other eggs served to a patient in the charity wards. The cost and quality of milk served to each of these patients would be the same. The bread and butter and other food commodities would not differ.

I am not sure that I am answering the questions that you have in mind in your communication, but the point that I am making should be emphasized in any formula that has for its object statistical information so far as costs are concerned in the care of patients in the hospital, and this, I think, should be borne in mind constantly. The cost of the essential and fundamental services which the hospital furnishes the patient and the cost of the commodities—foods, surgical dressings and supplies, bed linens and other staple articles, the cost of the heat, light and water furnished—do not differ so far as the patient is concerned whether the patient is a pay patient or a charity patient, and these fundamental and essential services and supplies in the aggregate form the vast bulk of hospital expenditures.