Journal of Accountancy

Volume 66 | Issue 3 Article 8

9-1938

Accounting Questions: Accounting Procedure for an Oil Company: Sale of Accountants Receivable

American Institute of Accountants. Bureau of Information

ACCOUNTING QUESTIONS

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ACCOUNTING PROCEDURE FOR AN OIL COMPANY

Question

The A Corporation purchases for $10,000 cash, the oil rights to five acres of land.

An undivided one-fourth interest in this oil right is transferred to D Drilling and Producing Company, in consideration of its drilling and equipping one oil well on the land.

The drilling is successful and the well produces 25 barrels of marketable oil.

On a cash contract basis, the D Drilling and Producing Company usually receives $6,000 for the labor and equipment which was expended on the five acres in question.

Three plans of accounting procedure present themselves to my mind:

Plan No. 1:

No entry whatever. Books take no cognizance of transaction.

Plan No. 2:

Debit drilling, rigging, and equipment (asset)	$2,500.00	
Credit lease on 5 acres		$2,500.00
A one-fourth interest transferred to D Drilling and Producing Company in consideration of its drilling and equipping one oil well on the 5 acres. Well producing 25 bbls. grade 2 oil daily. To set up asset at cost and to reduce cost of 5 acre lease by one-fourth.		

Plan No. 3:

Debit drilling, rigging, and equipment (asset)	4,500.00	
Credit lease on 5 acres		2,500.00
Credit profit on sale of leases		2,000.00
A one-fourth interest transferred to D Drilling and Producing Company in consideration of its drilling and equipping one oil well on the 5 acres. Well producing 25 bbls. grade 2 oil daily. Drilling, rigging, and equipment set up at three-fourths of usual cash cost for this type of well. One-fourth of cost of 5 acres costed out.		

I believe that plan No. 1 or plan No. 2 would be proper for income-tax procedure.

However, I can see no objection to using plan No. 3 for balance-sheet presentation.

Based upon the income-producing capacity of the well, capitalization at a fair rate of return would result in a value greatly in excess of the value which would result from the employment of plan No. 3.

Answer No. 1

The problem involved is one commonly met with in the producing end of the oil industry, and the answer to a large extent depends on the general methods used by the particular parties involved. In other words, there is no fixed plan, but alternatives which can be adopted, and our answer to the problem would be as follows:

The cost of the land, in the first place, was a known quantity, namely, $10,000, and the cost of drilling and equipping the well was also a known quantity, in this case assumed to be $6,000. Therefore, the cost to the two parties should be reflected on their accounts as $16,000. There should be no profit reflected to either party so long as they are involved in a joint venture, or until one or the other disposes of its interests therein. The transactions might be shown as follows on the books of the two parties:

Corporation A reflect on its accounts drilling and equipment—$4,500, leasehold costs—$5,500. The Drilling Company would then reflect on its accounts drilling and equipment—$1,500, leasehold costs—$4,500.

The entries might also be properly made to show the following on Corporation A's books: Leasehold costs—$7,500, drilling and equipment—$2,500; on the Drilling Company's books; Leasehold costs—$4,500, drilling and equipment—$1,500.

We would prefer, however, that no segregation be made between leasehold and equipment in a situation of this kind and that Corporation A's books show lease, development, and equipment costs—$10,000, and the Drilling Company's books show lease, development, and equipment costs—$6,000. The two would then amortize their respective costs in lease, development and equipment, through an annual charge for depreciation and depletion. This annual charge for depreciation and depletion would be measured by preparing an estimate of barrels of oil contained in the property, three-quarters of which would be allocated to Corporation A and one-quarter to the Drilling Company, who would then divide their respective costs by their proportionate share of the reserves, and the resulting unit would then be multiplied by their proportions of oil actually produced during a given year, to measure their annual charge for depreciation and depletion.

Answer No. 2

The procedure outlined in plan No. 2 appears to be correct. One fixed asset has been exchanged for another, and the improvement (the well) on A Corporation's land should be recorded at the cost of the asset given therefor (i.e., one-fourth of $10,000, the cost of the oil rights).

SALE OF ACCOUNTS RECEIVABLE

Question

We have had a question come up in connection with the examination of the books of one of our clients. During the year, the company sold some of its receivables, all of which had been collected and paid before the close of the fiscal year and in respect to which there was no contingent liability at that date. Naturally, the balance-sheet itself will not disclose the fact that the company had made it a practice to sell its receivables, since at the balance-sheet date there would be no liability on the company's part, either direct or contingent, in connection with these accounts. The question arises as to whether or not some mention should be made as a footnote on the balance-sheet, or in the comments accompanying the report, of the fact that the company had been selling its receivables during the year.

Answer No. 1

It seems quite obvious that it is not appropriate to put a footnote on the balance-sheet. As to whether anything should be said in the comments of the report, that would, in our opinion, depend upon the character of the report. If the report were to be so complete that the accountant would, for example, comment on the fact that the company had made direct borrowings from a bank during the period which had been entirely repaid at the end of the period, then it would seem appropriate to comment on the fact that the company had made such indirect borrowings as are involved here. We think that in general it is not incumbent upon the accountant to disclose business practices of his client other than as they are expressed by the accounts. In this case the necessary facts might well be stated by an adequate explanation in the income statement of the charges for interest paid during the period.

Answer No. 2

It is our opinion that inasmuch as there is no liability on the company's part, either direct or contingent in connection with the accounts receivable sold during the fiscal year, there is not any necessity to make reference to it on the company's balance-sheet.

We do think, however, that the cost in connection with the sale of these receivables should be shown on the profit-and-loss account as a special item, i.e., discount on receivables sold during the year, or something to the same effect. We think, too, that in any report accompanying the accounts, mention should be made to the effect that the company had been selling receivables during the year.

Answer No. 3

If the company referred to had sold or assigned its receivables during the year and these accounts had all been collected and no other accounts receivable had been assigned or sold so that the company owned all of its accounts at the date of the balance-sheet, I do not see how any mention of the fact that a transaction of this sort had taken place during the year would be required. If, however, for the sake of "window dressing," the company's affairs had been arranged so that no receivables were sold or assigned, say on December 31st, but say on December 1st there had been a number of accounts in this condition and it was the company's intention to sell or assign their accounts, say, in January, I believe some mention should be made of the situation. The pledge or sale of accounts receivable is generally a sign of financial weakness and it is a matter in which any credit grantor has a legitimate interest.

One other possible method of indicating that such a transaction had taken place might be to include in the income account an item, "Interest and charges on money borrowed on security of accounts receivable." It is a difficult question at best, as there is no doubt that a credit grantor should be informed of such a practice if there is any reason to suppose it will be resumed or continued. If the company sold or assigned its receivables in a period of temporary difficulty from which it has entirely extricated itself before the date of the balance-sheet, then I believe no mention of the fact would need to be made.