Query No. 24

Subject: Accounting treatment of dry development wells.[1]

A. Facts of the Case

1. A navaratna company in public sector, under the administrative control of the Ministry of Petroleum and Natural Gas, is engaged in exploration and development of oil fields; production, sale and transportation of crude oil and natural gas; production and sale of LPG and condensate; and transportation of finished petroleum products of other public sector undertaking (PSU) refineries to their marketing points. The company follows the Successful Efforts Method (SEM) of accounting for its oil and gas producing activities in accordance with the Guidance Note on Accounting for Oil and Gas Producing Activities (Revised) 2013, issued by the Institute of Chartered Accountants of India (ICAI).

2. The company undertakes development of the oil fields, which amongst others include drilling of development wells, service wells like water/gas injection wells, water disposal wells, laying lease flow lines, setting up of oil and separators, heaters, pumps, storage tanks, artificial lift, advanced recovery systems etc. after techno-commercial viability of the exploration effort in the area is established.

3. The querist has informed that the company's accounting policy towards accounting for development cost is as under:

> "Costs that are attributable to development activities including production and processing plant and facilities, service wells including allocated depreciation on support equipment and facilities are initially shown as tangible assets under capital work in progress as development cost till such time they are capitalised as producing properties upon determination of proved developed reserves."

Further, the company's accounting policy towards accounting for side-tracking expenditure is as under:

> "In case of development wells, the entire cost of abandoned portion and side-tracking is capitalised. ..."

4. Based on the above policies, the company capitalises development cost held in capital work in progress by transferring the same to the gross block of producing properties when proved developed reserves are established. Cost of any dry development well is also capitalised on completion of the well.

Views of the Comptroller and Auditor General (C&AG auditor) during the financial year 2015-16:

5. The querist has stated that as per the Guidance Note on Accounting for Oil and Gas Producing Activities (2013), the definition of development well is "a well drilled, deepened, completed or re-completed within the proved area of an oil or gas reservoir to the depth of a stratigraphic horizon known to be productive". Therefore, the development wells are not supposed to fail. The querist has further informed that during the year 2015-16, three

[1] Opinion finalised by the Committee on 16.1.2017.

development wells were found dry and wells were booked under tangible assets as producing properties. In the opinion of the CAG auditor, the expenditure incurred on drilling of development wells declared dry does not meet the definition and recognition criteria of an 'asset', as defined in paragraphs 49 and 88 of the Framework for Preparation and Presentation of Financial Statements, issued by the ICAI and Accounting Standard (AS) 26, 'Intangible Assets'. Therefore, the expenditure incurred on dry development wells should have been written off. This has resulted in overstatement of producing properties and overstatement of profit for the year.

Views of the company:

6. The querist has referred to paragraph 20 of the Guidance Note on Accounting for Oil and Gas Producing Activities (Revised 2013), issued by the ICAI, which states that all development costs related to proved developed oil and gas reserves will be capitalised on completion of the same. Also, as per paragraph 11(ii) of the Guidance Note referred above, development cost includes cost of successful and unsuccessful well cost. Hence, the treatment of the dry development wells is in line with the Guidance Note and industry practice. Accordingly, the cost of the dry wells has been capitalised to gross block of producing wells in the accounts for the financial year 2015-16.

7. Further, cost reflected in the statement of financial position of the company under the head producing wells corresponds to the proved developed reserves established by the company from which future economic benefit flows to the company. Development wells are drilled only after economic feasibility and commercial viability of the oil and gas reserves have been established. As a part of the development effort, if any development well is found to be dry, there is no change in the corresponding oil and gas reserves already found to be proved. Hence, cost of dry development well is a part of the total expenditure incurred to develop the reserves which are found to be proved.

B. Query

8. On the basis of the above, the querist has sought the opinion of the Committee on the following issues:

(i) Whether the accounting treatment followed by the company in respect of development wells including dry development wells is in line with the requirements of the Guidance Note.

(ii) What should be the correct accounting treatment of dry development well if the policy and practice of the company are not in line with the requirements of the Guidance Note?

(iii) Whether there is any violation by the company of requirements of paragraphs 49 and 88 of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI while following the aforesaid accounting treatment as contended by CAG auditor.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to accounting treatment in respect of dry development wells (which are part of the cost centre). Therefore,

the Committee has examined only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, propriety of determination of exploratory and development dry wells, accounting for exploratory wells, producing properties, propriety of accounting policy of the company in respect of other items of costs, such as, side-tracking, etc. At the outset, the Committee wishes to point out that in the absence of details pertaining to the costs of other development activities apart from the cost of dry development wells, such as nature of these activities, whether these are directly attributable or not to development activities, etc., the Committee has not examined the accounting treatment in respect of other development activities as whole. The Committee also wishes to point out that since the query has been raised in the context of financial year 2015-16, the opinion has been expressed considering the requirements of the Guidance Note on Accounting for Oil and Gas Producing Activities (Revised 2013), which was relevant and applicable during that financial year and not the requirements of the Guidance Note on Accounting for Oil and Gas Producing Activities (for entities to whom Ind AS is applicable).

10. With regard to development wells, the Committee notes the definition of the terms, 'cost centre' and 'development wells', as per paragraph 4 of the Guidance Note on Accounting for Oil and Gas Producing Activities (Revised 2013). These definitions and other relevant matters contained in other paragraphs of the Guidance Note are reproduced below

> "*Cost Centre*: Cost centre is a unit identified to capture costs based on suitable criteria such as geographical or geological factors. Cost centre is not larger than a field in case of Successful Efforts Method and under Full Cost Method, the cost centre is not normally smaller than a country except where warranted by major difference in economic, fiscal or other factors in the country."
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> *"Development Well:* A well drilled, deepened, completed or re-completed within the proved area of an oil or gas reservoir to the depth of a stratigraphic horizon known to be productive."
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> "11. Development costs cover all the directly attributable expenditure incurred in respect of the development activities including costs incurred to:
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> (i) gain access to and prepare well locations for drilling, including surveying well locations for the purpose of determining specific development drilling sites, … to the extent necessary in developing the proved oil and gas reserves;
>
> (ii) drill and equip development wells *(whether successful or unsuccessful*), development-type stratigraphic test wells and service wells including the cost of platforms and of well materials and equipment such as casing, tubing, pumping equipment and the wellhead assembly;
>
> …"
>
> (Emphasis supplied by the Committee.)
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> "18. Under the successful efforts method, in respect of a cost centre, the following costs should be treated as capital work-in-progress or intangible asset under development, as the case may be (refer paragraphs 46 and 47) when incurred:
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> (i) All acquisition costs;

(ii) Exploration costs referred to in paragraph 9 (iv) and (v); and

(iii) All development costs."

"20. When a well is ready to commence commercial production, the costs referred to in paragraph 18 (ii) and (iii) corresponding to proved developed oil and gas reserves should be capitalised as 'completed wells/producing wells' from capital work-in-progress/intangible assets under development to the gross block of assets. With respect to costs referred to in paragraph 18 (i), the entire costs should be capitalised from capital work-in-progress/intangible asset under development to the gross block of assets. Normally, a well is ready to commence commercial production on establishment of proved developed oil and gas reserves."

"37. No gain or loss should be recognised if only an individual well or individual item of equipment is abandoned as long as the remainder of the wells in the cost centre continues to produce oil or gas. When the last well on the cost centre ceases to produce and the entire cost centre is abandoned, gain or loss should be recognised."

"42. … In case of development wells, the entire costs of abandoned portion and side-tracking should be capitalised…"

11. From the definition of the term 'development well', the Committee notes that the said wells are drilled and developed in the proved area of oil or gas reserves and, therefore, are different from the exploration wells in respect of which the area is still to be considered to have proved oil reserves. The Committee further notes that the development cost covers all directly attributable expenditure incurred in respect of the development activities and includes cost incurred to drill and equip development wells (whether successful or unsuccessful). The Committee further notes from paragraphs 37 and 42 of the Guidance Note that gain or loss should not be recognised only if an individual well is abandoned as long as remaining wells in the cost centre continue to produce oil and gas and that in case of development wells, the entire costs of abandoned portion should be capitalised. Thus, the Committee notes that the Guidance Note requires the development costs to be considered in the context of proved area of oil and gas reserves and not individual wells, which might be successful or unsuccessful. The Committee is of the view that the expenditure incurred on developing dry wells is like a normal loss/ expenditure during construction or creation of an asset and, therefore, should be capitalised. Accordingly, in the extant case, the Committee is of the view that there is no need to expense off the expenditure incurred on dry development wells and the same should be capitalised unless the entire cost centre is abandoned. Therefore, the accounting treatment followed by the company to capitalise the costs incurred in respect of dry development wells to the gross block of assets/producing wells appears to be appropriate and in line with the requirements of the Guidance Note.

12. With regard to the contention of the C&AG auditor relating to future economic benefits considering the definition of 'asset' and the requirements of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI, the Committee wishes to point out that under Successful Efforts Method, the future economic benefits are considered in the context of the oil and gas reserves in the cost centre instead of individual wells which are part of that cost centre. Accordingly, the aforesaid accounting treatment is in accordance with the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI.

D. Opinion

13. On the basis of the above, the Committee is of the following opinion in respect of the issues raised by the querist in paragraph 8 above:

(i) Subject to paragraph 9 above, the accounting treatment followed by the company in respect of dry development wells appears to be in line with the requirements of the Guidance Note, as discussed in paragraph 11 above.

(ii) In view of (i) above, answer to this question does not arise.

(iii) As discussed in paragraph 12 above, there would be no violation by the company of the requirements of paragraphs 49 and 88 of the Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI while following the aforesaid accounting treatment with regard to the dry development wells.

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