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Full Cost versus Successful Efforts Accounting

With oil prices rising and increased activity in the private equity market, there are more and more new companies being formed. Deciding which accounting method to use is one of many decisions management will need to make. U.S. companies follow one of two methods of financial accounting for petroleum E&P activities, successful efforts or full cost. Although both are historical cost methods, significant differences exist between full cost and successful efforts accounting. Knowing and understanding those differences are key factors in determining which method is right for you.

Full Cost Accounting

Under the full cost accounting method, owners will capitalize all acquisition, exploration, and development costs even if they result in a dry hole. There is no need to expense any costs related to the purchase or development of oil and gas properties under this method. The only instance that will allow for this type of cost to be expensed is in the case of impairment. From a simplicity standpoint full cost is much easier to administer as it does not require a company's accounting department to separate exploration and development costs. It also allows for one depletion entry using only proved reserves. The downside to this method is that it creates higher basis in properties and thus a higher chance of impairment during a price downturn.

Successful Efforts Accounting

The successful efforts accounting method is the more prevalent of the two methods for large companies. A recent survey found that 13 of the 20 largest publicly traded U.S. petroleum companies use successful efforts. This method capitalizes only the costs directly related to specific oil and gas reserves when results are positive, i.e., minerals are found. Thus, the costs of drilling and equipping "successful" exploratory wells and development costs are capitalized. Costs that are not directly linked to specific reserves are expensed. The cost of exploratory dry holes, most geological and geophysical (G&G) costs, delay rentals, and other property carrying costs are expensed in the period incurred. One common misconception is that any dry hole is expensed under this method; however, only those dry hole costs associated with exploratory wells are expensed. The benefit to this method is that it more accurately reflects the value of developed properties and during a period of lower commodity prices, has a lower risk of being impaired. The downside to this method is that it creates additional classification detail by the accounting department to separate cost for capitalization and expensing as well as creating an additional depletion calculation as acquisition costs are depleted separately from exploration and development.

Key Differences

As illustrated above, the successful efforts and full cost accounting methods differ significantly. Key differences to keep in mind when deciding on which method is right for your company are: differences in basis, additional accounting burden to ensure proper classification and depletion calculations, and the chance of impairment during a market downturn.

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