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The Use of Reserve Reports for GAAP Financial Statements

When preparing GAAP financial statements the accounting department uses reserve reports to calculate depletion, evaluate for impairment or ceiling test, and initially calculate each wells asset retirement obligation ("ARO"). All of these calculations have a material impact on a company's financial statements.

Depletion

The pricing of the remaining reserves is the single most important input for the accounting department as that number has a direct effect on the economical reserves that will be produced. Under Accounting Standard Codification 932, a company must use the average, first-day-of-the-month price during the twelve-month period before the ending date of the period covered by the report (the twelve-month average price) when estimating whether reserve quantities are economical to produce. Under certain circumstances (falling prices) this can be beneficial to the company, under others (increasing prices) this can be detrimental, as the lower the reserve base the higher the depletion expense for the year relative to the remaining basis.

Impairment or Ceiling Test

The impairment (successful efforts) or ceiling test (full cost) is a calculation required to be performed by a company when events or circumstances indicate that the carrying amount of oil and gas properties may not be recoverable in order to identify any property groupings that should be written down. The FASB allows for two different reserve reports to be used depending on the accounting method elected. Under the successful efforts method of accounting a company can use a reserve report prepared using forward strip pricing to calculate the future value of remaining reserves for impairment purposes. However, companies that have elected the full cost method of accounting must use the reserve report based on the twelve-month average price (discussed above) in their ceiling test computation.

Asset Retirement Obligation

The purpose of the ARO is to record a liability for the future obligation of the company to plug and abandon a well. There is no requirement to use a certain reserve report, however, a company should use a useful life that most reasonably reflects the life of the well. Based on my experience, an operator will delay plugging a well as long as possible as the expenditure to do so is a sunk cost and will never be recovered. This results in wells being operated far past their economic life. Under these circumstances it is best to use a reserve report most refer to as a "loss run okay" report. This allows for the life of wells to be calculated to the point where no more hydrocarbons remain to be produced.

As you can see, there is not a one size fits all reserve report and your accounting department needs to be aware of the importance of each type.

For questions or additional information please contact Taylor Mathews, Oil and Gas Specialist, at TaylorM@gmpcpa.com or 903-534-0088.