I. AN OVERVIEW IN PERSPECTIVE

Following two years of extensive study and evaluation, on December 5, 1977 the Financial Accounting Standards Board (FASB or Board) issued its Statement of Financial Accounting Standards No. 19, "Financial Accounting and Reporting by Oil and Gas Producing Companies," effective for financial reports beginning in 1979. The Board issued Statement No. 19 under its authority to establish and improve financial accounting and reporting standards, and also to assist the Securities and Exchange Commission (Commission) in carrying out its obligations as contemplated by Congress under the Energy Policy and Conservation Act of 1975 (EPCA) and under the Federal Securities Laws.

Statement No. 19 prescribes a single accounting method for all companies engaged in oil and gas producing activities by requiring a form of "successful efforts" accounting to be adopted retroactively for costs incurred in exploring for and developing oil and gas reserves. Specifically, Statement No. 19 requires, among other things, that exploration costs that do not result in discovery of commercial quantities of oil and gas reserves shall be charged to expense. Statement No. 19 thus proscribes the myriad of "free choice" accounting alternatives, including the many variations of both the "full cost" and "successful efforts" methods presently

found in practice, that have undermined the reliability, comparability, and utility -- and thus credibility -- of financial and data reporting by oil and gas producers for years.

Three of the FASB's seven members dissented for various technical reasons to the issuance of Statement No. 19. However, all of the FASB's members, including those dissenting, rejected the "full cost" method -- that is, capitalizing the costs of exploration efforts in geological areas where no reserves are found, simply because the reporting entity previously discovered valuable reserves in some other, unrelated geological area.

The Board concluded that a principal defect of the full cost method is that it tends to obscure risk and failure of unsuccessful exploratory activities.* Successful efforts, on the other hand, highlights those failures and the risks inherent in oil and gas exploration, by charging currently to expense exploration costs known not to have resulted in the discovery of reserves. By contrast, the full cost method considers "unsuccesssful costs" to be assets.

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* The Board's many reasons for accepting successful efforts and rejecting full cost are summarized in paragraphs 128-132 and 142-188 of Statement No. 19. The Board's reasons for rejecting "discovery value" and "current value" accounting are summarized in paragraphs 133-141.

In Statement No. 19 the Board viewed discovery of oil and gas reserves as the critical event for determining a producer's success or failure, and for investors, lenders and other capital suppliers in assessing risks and rewards in their investment and credit decisions.

The Board recognized that neither full cost nor successful efforts reflects success at the time of discovery, since as a consequence of historical cost accounting both methods report success when production is sold. Therefore, to provide information about success as well as failure, Statement No. 19 requires disclosure of capitalized costs and costs incurred in oil and gas producing activities (to provide an indication of effort) and of reserve quantities and changes in reserves (to provide an indication of accomplishment).*

In prescribing successful efforts as the single accounting method for oil and gas producers, the FASB assessed the information and data made available to and obtained by it and reached conclusions on possible economic consequences, including possible adverse effects on aspects of energy supply and competition. In brief, the Board did not find information

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* In Securities Act Release No. 5878 (October 26, 1977) the Commission issued a rule-making proposal that information filed with it also contain information on the present value of estimated cash flows from future production of proved oil and gas reserves.

persuasive as to claimed possible adverse effects, either generally or for small, independent producers, including those in the start-up or development stages. To the contrary, the weight of the evidence before the Board was that independent oil and gas producing companies using the successful efforts method compete successfully and conduct effective exploration and production programs that they are able to finance through a variety of capital sources -- and they have done so for many years, long before the use of full costing became popular in the late 1960's.

The Board further concluded that Statement No. 19 would foster fair and effective competition in the capital markets by (1) providing investors, lenders, and other suppliers of capital with comparable financial data prepared objectively and even-handedly and permitting consistent analysis of risks and rewards; (2) relieving the capital markets of the anticompetitive burdens of unreliable, non-comparable, inconsistent and subjective financial data; and (3) eliminating the possibility of inequities affecting allocation of capital resources to and among oil and gas producers -- principally the independent producers -- resulting from inadequate and misunderstood financial data.

As discussed fully below, the FASB issued Statement No. 19 only after:

(1) the Board and its technical staff devoted two years to considering the issues and gathering, reviewing, and evaluating relevant information and data made available or obtained;

(2) extensive "due process", far exceeding the requirements of the Administrative Procedures Act, permitting all who wished to participate to do so, at the Board's four days of public hearings, by written comments or otherwise; and

(3) consultation and continuing liaison with observers and representatives of the Federal Energy Administration and Department of Energy, Federal Power Commission (now FERC), Securities and Exchange Commission, United States General Accounting Office, House Subcommittee on Oversight and Investigations of the Committee on Interstate and Foreign Commerce, and the Cost Accounting Standards Board.

In the judgment of the FASB, Statement No. 19 provides a sound framework within which a national energy data base can be developed by the Department of Energy (DOE), and provides the Commission with accounting practices that it may reasonably rely on in meeting its obligations under Section 503 of EPCA and under the Federal Securities Laws.

II. EVENTS LEADING TO STATEMENT NO. 19

A. The Problem

Financial accounting and reporting for oil and gas producing companies has been debated since at least 1964 within the accounting profession, by regulatory agencies, industry groups and accounting scholars, among financial analysts and other users of financial statements, and among the companies themselves. The principal focus of the controversy was whether the "successful efforts" method of expensing unsuccessful exploration costs, or the "full cost" method of capitalizing all (including unsuccessful) exploration costs, was preferable.

As the debate continued into and through the 1970's, it became increasingly apparent, both within the private sector and to Congress and concerned regulatory agencies, that the existence of these two principal, but highly disparate, accounting methods (and the many variations of each) resulted in a lack of comparability and reduced reliability and utility in the financial statements and data reporting of oil and gas producing companies. This in turn was widely perceived as impairing public confidence in the financial and operating data reported by the oil and gas producers, impeding the equitable allocation of capital resources in the capital markets, and seriously hindering data collection and evaluation and the formulation of national policy by Government.

B. Governmental and Regulatory Responses

1. Energy Legislation

In recognition of the lack of reliable and comparable financial and operating data for oil and gas producers, Congress enacted the Energy Policy and Conservation Act of 1975 requiring the development of a reliable energy data base and providing for development of accounting practices for oil and gas producers to be followed for that purpose. EPCA requires the Securities and Exchange Commission to assure the development of these accounting practices for oil and gas producers and authorizes the Commission to prescribe rules with respect to such accounting practices or, alternatively, to recognize or otherwise rely on accounting practices developed by the FASB. The intent of EPCA, as seen through its legislative history and the statements of Government officials and the Commission (see below), is to obtain uniform reporting of reliable energy data to the DOE.

The data required to be developed through formulation of accounting practices mandated by Section 503 of EPCA involve accounting measurement standards of the type used in the preparation of general purpose financial statements and over which the FASB, with Commission oversight, has authority. For example, Section 503 requires these accounting practices to address such issues as revenue and cost recognition, disposition of capitalized costs, accounting for contractual arrangements involving special conveyance of rights and joint operations, and differences between book and tax income.

In August 1977 Congress enacted the Department of Energy Organization Act (DOE Act) as a mechanism for formulating and implementing a coordinated national energy policy. The DOE Act is intended, among other things, to "continue and improve the effectiveness and objectivity of a central energy data collection and analysis program." Thus, Section 205 establishes the Energy Information Administration and charges its Administrator with responsibility for carrying out a central, comprehensive, and unified energy data information program. Section 205(h)(2) requires the Administrator to develop the format for an energy-producing company financial report "designed to allow comparison on a uniform and standardized basis among energy-producing companies" of information such as revenues, profits, cash flow, energy related investments, costs associated with exploration, development and production, and segregated information, including financial information, as to operations by energy source and geographic area. Section 205(h)(3) relates the DOE Act to EPCA, by requiring the Administrator to consult with the Chairman of the Securities and Exchange Commission on the development of the accounting practices required by EPCA to assure that the energy-producing company financial report described in Section 205(h)(2), to the extent practicable and consistent with the DOE Act, is consistent with the EPCA accounting practices where applicable.

2. Securities and Exchange Commission

Wholly apart from its responsibilities under EPCA or in consulting with the Administrator under the DOE Act, the Commission has been charged for nearly 45 years with the responsibility and has broad authority to prescribe accounting practices to be applied in the preparation and presentation of financial statements and other financial data to be included in filings with the Commission pursuant to the Federal Securities Laws.

As summarized in Securities Act Release No. 5877 (October 26, 1977), for many years the Commission has been concerned about the diversity in the accounting and financial reporting practices of oil and gas producers and has made several efforts to resolve this problem. In 1964 the Commission's staff urged the oil and gas industry and the accounting profession to address the lack of comparability in reporting for petroleum companies. From 1968 to 1972 the Commission's staff monitored the activities of the FASB's predecessor body, the Accounting Principles Board, as it attempted to achieve more uniformity in financial reporting by oil and gas producers. In 1972 and 1973 the Commission made various proposals involving supplemental disclosure in an attempt to alleviate the diversity of financial reporting, but these proposals were strongly

opposed within the petroleum industry and in view of significant implementational problems were not adopted.

The concerns of the Commission over accounting in the petroleum industry continued into 1975 when Congress was considering EPCA and proposals with respect to the energy data base and the accounting practices now contained in Section 503. In a letter on August 22, 1975 to Congressman John E. Moss, Chairman Garrett wrote:

> "We [the Commission] recognize that at the present time there are diverse accounting practices existing in the petroleum industry which make the development of a data base difficult and preclude meaningful comparisons among companies. Because of this we agree that more standardization of accounting practices is needed in the petroleum industry."

The Commission currently has outstanding three rule-making proposals relating to accounting and reporting practices for oil and gas producers. In Securities Act Release No. 5861 (August 31, 1977), the Commission proposed rules pertaining to accounting measurement standards, essentially proposing to adopt the FASB's conclusions in its July 15, 1977 Exposure Draft of Statement No. 19; and in Securities Act Releases Nos. 5877 and 5878 (October 26, 1977), the Commission proposed rules for disclosure of related financial and operating data by persons engaged in oil and gas producing activities,

including essentially the disclosures in the FASB's Exposure Draft and, additionally, information on the present value of estimated cash flows from future production of proved oil and gas reserves. The Commission has indicated that, if adopted, its proposed rules would apply both (1) to the preparation and presentation of financial statements to be included in filings with the Commission pursuant to the Federal Securities Laws, and (2) to the compilation of financial and related operating data for reporting to the DOE by persons subject to the reporting requirements of EPCA.

In Release No. 5877, the Commission discussed the relationship between data reporting to the DOE and financial reporting to investors:

> "The Commission views the FASB's project on oil and gas accounting as being useful in two respects. First, the project is expected to result in significant improvement in financial reporting through the establishment of uniform accounting standards so that investors are provided with a valid basis for comparing the financial statements of different companies. Secondly, the generally accepted accounting principles promulgated by the FASB in this project are expected to be useful to the Commission in fulfilling its responsibilities under the EPCA.
>
> "The issues relating to accounting measurement standards applicable to the preparation of financial statements are the same, whether they are considered from the standpoint of reporting to the DOE pursuant to the EPCA or from the standpoint of issuing financial statements for use by investors. The EPCA specifically requires

that the accounting practices to be developed thereunder address issues such as revenue and cost recognition, disposition of capitalized costs, and accounting for contractual arrangements involving special conveyance of rights and joint operations. These and other issues specifically required to be addressed under the EPCA involve accounting measurement standards used to prepare financial statements.

* * *

"Uniformity of reporting to investors is as desirable, in the Commission's view, as uniform reporting to DOE. Since the basis of reporting to DOE is essentially the same as reporting to investors, the Commission does not consider the separation of issues related to reporting to DOE and reporting to investors to be practicable or consistent with the Commission's responsibilities under the Federal securities laws."

The Commission is also considering possible economic consequences in connection with its accounting and disclosure proposals.

In Release No. 5861, the Commission indicated that it had reviewed the submissions to the FASB concerning potential impact on competition resulting from the proposed selection of the successful efforts method and solicited additional comments on this matter. Comments were again solicited in Release No. 5877. On December 22, 1977, following issuance of Statement No. 19, the Commission announced in Securities Act Release No. 5892 that it would hold hearings to solicit further public comment on whether the Commission should rely on Statement No. 19 as authorized by EPCA and, further, on whether that Statement's accounting standards would be

appropriate for the preparation of financial statements to be included in filings pursuant to the Federal Securities Laws and in reports filed with the DOE.

In Release No. 5892, the Commission also summarized the positions advanced by certain commentators on the economic impact of FASB Statement No. 19 and summarized some of the information and data reviewed by the FASB in reaching its conclusions that Statement No. 19 would foster, not burden, competition and would not have the adverse economic impacts predicted by some. The Commission again solicited additional comments on these issues and encouraged commentators to address the views previously presented by others to the Commission and the FASB, as well as the FASB's conclusions on these matters in Statement No. 19.

As contemplated by EPCA, the Commission has been consulting with the Federal Energy Administration, the FPC and, since its formation, the DOE, among others, and its staff has worked closely with their staffs over the past two years in developing a petroleum company financial reporting system (FRS), one of the subjects of the DOE hearings held on February 21 and 22, 1978. The Commission summarized the scope and nature of those activities in Release No. 5877 and in Release No. 5892.

III. FASB STATEMENT NO. 19

A. Summary of Competitive and Economic Conclusions

In deciding in Statement No. 19 that there should be a single accounting method for oil and gas producers and that successful efforts, and not full cost, should be the single method, the Board assessed and reached conclusions as to possible economic consequences, including possible adverse effects on aspects of competition and energy supply.

The Board's conclusions reflect that:

1. Different accounting for the same or similar facts and circumstances impedes comparability and consistency of financial statements and significantly detracts from their usefulness. The facts and circumstances surrounding the search for, development and production of oil and gas are similar for all companies and do not differ because of a company's size or whether its securities are publicly traded. The effects on companies' reported results of a requirement to use only one accounting method, and the effects, if any, of such a requirement on the stock prices or on the costs of capital of particular companies, are the results of differences in accounting methods - not differences in industry or operating facts or circumstances, and certainly not justifications for continuing accounting alternatives.

2. The adoption of a single accounting method presenting comparable and consistent financial and operating data by companies experiencing similar types of risks and potential rewards, and competing for like capital resources, is in the public interest. Uniform accounting for similar facts and circumstances provides an equality in "score-keeping" that enhances competition. A marketplace burdened by the effects of inconsistency, noncomparability, and misunderstanding of financial data is anticompetitive and cannot assure equitable allocation of capital resources.

3. Capital resources are most efficiently and equitably allocated, and the national goals of competition in oil and gas exploration, development, and production are best fostered and likelihood of attainment increased, if all competitors disclose financial data on a comparable and consistent basis, where industry risks and rewards to the extent reflected in financial statements are reported as objectively and as even-handedly as possible. Sophisticated investors may understand the implications of accounting alternatives and consider industry and supplemental data in making their decisions, but the broad public can only be hindered in its understanding of economic facts if relevant information is noncomparable and misunderstood because of accounting differences.

4. A single accounting method facilitates the aggregation of accounting information into a meaningful data base. If each company's results must be adjusted to achieve industry consistency and comparability, the task of developing energy data for a useful energy data base can only be more difficult and costly. While it may be theoretically possible to mandate one accounting practice for purposes of energy data collection and to permit oil and gas producers to utilize another method or alternatives for reporting to investors, this would entail the maintenance of additional records and increase economic costs to them and ultimately to consumers. These burdens would be particularly severe for small independent producers, some of which are on record as opposing unnecessary regulatory reporting burdens.

5. Persuasive information was neither presented nor obtained supporting assertions that adoption of successful efforts and prohibiting full cost would inhibit competition in exploration, development, and production of oil and gas or in financing those activities. The weight of the evidence before the FASB was that independent oil and gas producing companies using successful efforts accounting compete successfully and conduct effective exploration and production programs that they are able to finance through a variety of capital sources. As conceded even by advocates of full cost, the

accounting change to successful efforts prescribed by Statement No. 19 has no effect and in no way alters, among other things, any company's cash flow, the value of its oil and gas reserves, its costs of exploration, development, or production, oil and gas pricing or other marketplace characteristics, the success or failure of exploratory or development activities, including prospects of finding commercially recoverable reserves, or its income tax payments.

6. While a change to Statement No. 19's successful efforts method may reduce reported earnings and retained earnings, perhaps significantly, in the short run, in the long run differences in reporting results under that method as compared to full cost can narrow significantly. The Board found evidence persuasive to the effect that, in addition to earnings and other information in financial statements, investors, lenders, and other suppliers of capital relied significantly, in many cases principally, in their investment and credit decisions on a company's exploration track record, its oil and gas reserve position, its cash flow, and like economic indicators. To the extent, however, that investors and creditors looked to financial statements as an important source of information, the Board found their focus to be principally on earnings - in particular earnings variability - as an indication of risks and returns. Consequently, the Board was influenced significantly by the

successful efforts characteristic of highlighting failures and the risks involved in oil and gas exploration, and by the fact that only the full cost method obscures failure.

7. The evidence with respect to new companies in the start-up or development stage was that whether these new companies defer or expense costs has little effect on the amount of venture capital provided them or the terms under which it is provided. In any event, the Board found it likely that most new exploration companies would be reporting operating losses and cumulative deficits for a period of time regardless of whether on full cost or successful efforts accounting, for most full cost advocates view a reserve value "cover" or "limitation" on capitalized costs as essential to use of full costing.

8. The Board did not find persuasive, contentions that by using the full cost method, asset carrying amounts reported in the balance sheet would be "closer" to the current values of most companies' oil and gas reserves than they would be under successful efforts. The Board concluded that under neither method do costs to acquire, explore and develop reserves indicate values of reserve discovered. Values change continually based on revisions to reserve estimates, development costs, production costs, taxes, timing of development and production, selling prices, appropriate discount rates, and regulatory and Government determinations

and policy. On the other hand, capitalized costs do not change. Since both full cost and successful efforts are based on historical costs, neither method is intended to, nor does it, portray current values. The Board decided to require disclosure of capitalized costs and costs incurred in oil and gas producing activities, and of reserve quantities and changes in reserves, to provide indications of effort and accomplishment.

9. While some advocates of full cost contend that managements would be more inclined under successful efforts to "smooth" periodic earnings by delaying, or expediting, exploration efforts or, in some cases, to reduce exploration expenditures, the Board found those possibilities not unique to the successful efforts method; it is inherent in the transaction-oriented accounting framework used by all companies in all industries. Indeed full cost is itself a method of "averaging", or "smoothing", reported earnings over long periods of time. Accordingly, the Board did not believe that those possibilities should bear importantly on the accounting decisions in its oil and gas project. Even if accounting results were to influence some managers' decisions, it does not follow that accounting standards should be designed to accomplish or prevent an action by management. That type of accounting standard would require a judgment by

the Board as to which potential actions are desirable and which are undesirable. Accounting should evenhandedly report economic actions taken, regardless of motivation. Accounting should not obscure the effect of actions and events in order to prevent what some might believe to be "uneconomic" actions.

10. For the reasons summarized in paragraphs 133-141 of Statement No. 19 the FASB rejected the discovery value and current value bases of accounting for oil and gas producers at this time. Value accounting, and issues relating to accounting measurement bases, are presently being considered as a part of the Board's Conceptual Framework project, and the FASB concluded not to resolve these issues at this time in the narrow context of the oil and gas industry.*

11. The Board also rejected an "area-of-interest" approach for the reasons summarized in paragraphs 190-192.

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* In view of the emphasis in Section 205(h)(2) of the DOE Act and Section 503 of EPCA on "costs," it is doubtful that a value approach in the accounting practices to underlie the energy data base would be consistent with the intent of those Acts. The Board's recent hearings in its Conceptual Framework project clearly indicate that a great deal of study and research must be undertaken, including experimentation, before value accounting could, if ever, replace historical cost, either generally or in specific cases. In any event, a proposal by the Commission in Securities Act Release No. 5878 (October 26, 1977) would, if adopted, require disclosure of the present value of estimated cash flows from future production of proved oil and gas reserves in filings with the Commission.

B. FASB "Due Process"

The Board reached its conclusions and issued Statement No. 19 only after a two-year study, review and evaluation of extensive information and data submitted to or obtained by it, as summarized in paragraphs 65-96 of Statement No. 19. Apart from the record of the FASB's own proceedings, the Board, its technical staff and an experienced and diverse Task Force considered many research studies and publications on both sides of the successful efforts/full cost controversy, including the proceedings of the Accounting Principles Board from 1970-1973, and over 100 publications on accounting and reporting in the extractive industries written generally within the past ten years.

The Board's efforts to encourage maximum public participation in its consideration and resolution of the oil and gas accounting controversy reflect "due process" far exceeding that required of Government agencies by the Administrative Procedures Act:

- The FASB's staff and an 18-member Task Force (with representatives from the oil and gas industry, public accounting, the banking and securities industries, the mining industry and academe) assisted the Board in analyzing the issues related to the project and in preparing a comprehensive Discussion Memorandum. Task force meetings were attended by observers from several Federal agencies (the FEA, the FPC, the Commission, the United States General Accounting Office, and the Cost Accounting Standards Board) and a Congressional Subcommittee, and liaison with those groups was maintained throughout the Board's review and deliberative processes. The FASB has made available to each of those

observer groups copies of all letters of comment and position papers received on the Discussion Memorandum and the July 5, 1977 Exposure Draft of Statement No. 19, its public hearings transcript, and other information and data in the FASB's public files. The FASB's public record has been included by the Commission in the public record of its proceedings and has been submitted to the DOE for inclusion in the record of its public hearings.

- 140 position papers, letters of comments and outlines (totalling 2,600 pages) were received in response to the FASB's December 1976 Discussion Memorandum (which the Board issued to set forth the accounting and reporting issues and the arguments and implications of accepting certain alternatives and rejecting others).

- Public hearings were held on March 30 and 31 and April 1 and 4, 1977. Everyone requesting an opportunity to be heard was scheduled, and 39 presentations were made resulting in a transcript of over 1,000 pages in length.

- Outside experts, including petroleum engineers and geologists, public accountants, oil and gas industry executives, and academicians, were called upon to assist the FASB staff in conducting seven days of concentrated preparatory sessions for Board members held prior to deliberations on the issues.

- Subsequent to issuance of the Discussion Memorandum two supplementary research studies were undertaken prior to issuance of the July 15, 1977 Exposure Draft (see paragraph 90 of Statement No. 19).

- The FASB received letters of comment on its Exposure Draft from 195 respondents (totalling 1,300 pages).

- Subsequent to issuance of the Exposure Draft, two additional supplementary research studies were conducted (see paragraph 93 of Statement No. 19).

- In September, Board representatives met at the request of a number of full cost advocates to discuss the Exposure Draft and the Board's proposed accounting standards.

- Over 28,000 copies of the Discussion Memorandum and more than 45,000 copies of the Exposure Draft (including gratis copies of each to anyone so requesting) were distributed by the Board prior to issuance of Statement No. 19.

- The Securities and Exchange Commission issued Releases in January, August, and October calling attention to the FASB's oil and gas project and urging interested parties to comment on the issues and to participate in the Board's proceedings.
- The DOE (then FEA) published an announcement in the September 7, 1977 Federal Register urging interested parties to comment on the Commission's proposals in Securities Act Release No.5861 (August 31, 1977) to adopt the accounting requirements proposed by the FASB in its July 15, 1977 Exposure Draft.
- Subsequent to the issuance of Statement No. 19 on December 5, 1977, the post-issuance supplementary research study mentioned in paragraph 93(a) was undertaken, and completed prior to the DOE's public hearings on February 21 and 22, 1978.

The Board's care in assuring that numerous opportunities to comment were available to all in and of itself imposes significant burdens on anyone now seeking to reject or reform Statement No. 19.

IV. BASES FOR THE FASB's COMPETITIVE AND ECONOMIC CONCLUSIONS

A. Uniform Accounting for Oil and Gas Producers

It has been asserted by some that requiring a single accounting method for financial accounting and reporting purposes will adversely affect the ability of those small independent producers that have been using full cost to compete in the capital markets, and that this will result in reduced energy supply.

In Statement No. 19 the FASB considered and rejected those arguments, as discussed at various places in paragraphs 128-132 and paragraphs 157-174, and as discussed above. The Board concluded that the search for and development and

production of oil and gas did not involve different facts and circumstances simply because a company is relatively small or privately held, and that comparable financial reporting of similar facts and circumstances by companies in the same industry was most in the public interest. The Board went on to conclude that, far from being anti-competitive, the mandating of one accounting method would eliminate the burdens of inconsistency, noncomparability and misunderstanding on the capital markets and foster competition in capital allocation by having all companies reporting comparable data as objectively and as even-handedly as possible.

1. Policy Considerations

The desirable -- in the Board's view, necessary -- goal of eliminating alternative accounting practices for oil and gas producers has been mandated by Congress in recent national energy legislation.

In Section 205(h)(2) of the DOE Act Congress mandated the development of an energy-producing company financial report to allow "comparison on a uniform and standardized basis among energy-producing companies" of revenues, profits, cash flows, exploration, development and production costs, energy related investments and other information. These requirements are complementary to Section 503 of EPCA, which Congress also intended to result in the uniform reporting of reliable energy data to the DOE.

Others, within both the private sector and Government, are similarly on record in favor of uniform accounting practices for the energy data and financial reporting of oil and gas producers. For example,

- Two major financial statement user groups -- the Financial Accounting Policy Committee of the Financial Analysts Federation (the national professional association of security analysts) and The Robert Morris Associates (the national professional association of bank lending officers) -- have endorsed elimination of free choice accounting alternatives, not only for oil and gas producing companies, but for other industries as well. (See paragraph 132 of Statement No. 19).

- Senate and House Subcommittees have each reached similar conclusions, as evidenced by the strong criticism of the availability of alternative accounting principles in the 1976 Report entitled "Federal Regulation and Regulatory Reform" issued by the House Subcommittee on Oversight and Investigations, and in a 1976 Staff Study, and the related 1977 Report, of the Senate Subcommittee on Reports, Accounting and Management. The Senate Subcommittee Report stated that "uniformity in the development and application of accounting standards must be a major goal of the standard-setting system." Both the 1976 House Report and the 1976 Senate Staff Study cited the oil and gas producing industry as a situation where uniform accounting was particularly needed.

- The Securities and Exchange Commission took a similar position in Securities Act Release No. 5877 (October 26, 1977), stating that the FASB's oil and gas project "is expected to result in significant improvement in financial reporting through the establishment of uniform accounting standards so that investors are provided with a valid basis for comparing the financial statements of different companies." This Release went on as follows: "Uniformity of reporting to investors is as desirable, in the Commission's view, as uniform reporting to DOE. Since the basis of reporting to DOE is essentially the same as reporting to investors, the Commission does not consider the separation of issues related to reporting to DOE and reporting to investors to be practicable or consistent with the Commission's responsibilities under the Federal securities laws."

- Congressman John E. Moss, an author of Section 503 of EPCA, wrote on October 25, 1977 to the Senate/House Energy Conferees with respect to the Senate's since - rejected Haskell/Bartlett Amendment to Section 503 (which was then being perceived in some quarters as permitting continuation of accounting alternatives for oil and gas producers):

  "Although a primary focus of EPCA was to create a repository of reliable energy data available to the Congress, it was also contemplated that the SEC would bring the same uniform standards to bear on reporting to shareholders and others under the federal securities laws.

  "If the practices proposed by the SEC for reporting to the Department of Energy are sound -- as I believe they are -- are they any less sound for reporting under the federal securities laws? The Department of Energy reporting requirement was designed to elicit accurate, comparable energy data to which the Congress could turn in fashioning energy legislation to conserve and allocate precious resources. It is equally important to ensure disclosure to the investing public of the same accurate, comparable energy data, so as to achieve an efficient allocation of resources through the forces of the marketplace."

- The Comptroller General of the United States wrote the Senate/House Energy Conferees on the same subject on November 7, 1977:

  "For years, the different accounting alternatives available to oil and gas producers have been a subject of controversy in the accounting profession. Transactions that are identical in nature and economic substance are often accorded very different treatment in producers' financial statements. The resultant lack of comparability in the data published by these producers has frustrated investors and policymakers alike. Meaningful comparisons of the companies' financial statements and aggregations of industry-wide data often cannot be made. It was this situation that gave rise to the passage of Section 503 of the Energy Policy and Conservation Act.

"We believe that it would be inappropriate at this crucial point for the Government to take any action which would undermine successful completion of the coordinated FASB-SEC effort. From our observer role, we conclude that the FASB has done a commendable job of researching a difficult technical accounting issue and providing the forum for full public debate and input by all interested parties in arriving at its position regarding standards for oil and gas producers.

"We believe the coordinated approach followed by the FASB and SEC is in the best interests of the Nation. It maintains the long-standing role of the private sector in developing financial reporting standards and, at the same time, assures that those standards are consistent with the practices followed in reporting information to the Federal Government.

"Certainly, we believe it would only create confusion to have a producing company report one set of financial data to the Federal Government and yet another to its shareholders. It does not seem logical for our securities markets to allocate resources based upon a different set of data than that supporting our national energy policy. Such a situation can only add to the confusion which confronts the users of energy data, policymakers and investors alike."

These statements, on the part of independent and objective public and private bodies and Government officials, express important policy considerations, and are significant to assessing Statement No. 19 and to anyone commenting to the Commission on its oil and gas proposals.

Also of significance to the DOE's inquiry and the Commission's hearings, Arthur Andersen & Co., a major international accounting firm and perhaps the accounting profession's most ardent advocate of full cost, addressed the uniformity issue in its February 16, 1978 response to the DOE's request

for comments on Statement No. 19. While advocating full cost and recommending that the Commission following its hearings remand Statement No. 19 to the FASB for revision, Arthur Andersen & Co. was unequivocal in its support of sound and uniform accounting standards for oil and gas producing activities, and that accounting standards should be established by the private sector through the FASB. In supporting uniformity, for both energy data and financial reporting purposes, Arthur Andersen & Co. wrote:

> "<u>One Set of Accounting Standards Desirable</u>
>
> * * *
>
> "We believe that the public interest will be best served by having sound and uniform accounting standards and principles for oil and gas producing activities that will be equally applicable for reporting to the DOE and for filings with the SEC under the Federal securities laws. The objective in both cases should be to achieve the best possible reflection of the economic facts that result from the transactions consummated by oil and gas producing companies. The information that is needed in both cases is an impartial and unbiased reporting of the results of economic activities in the industry.
>
> "If different reporting standards were permitted for the FRS or if different reporting standards were established for reporting under the FRS and the Federal securities laws, the integrity of the financial statements under both methods could, and undoubtedly would, be subject to question and criticism." (pp. 3-4.)

2. Fostering Competition

Those advocates of the full cost method who assert that access to capital and capital costs would be adversely affected by Statement No. 19 evidently perceive that full cost companies presently enjoy a competitive advantage in the capital markets over their successful efforts competitors. To the extent that advantage results from the fact that full cost acounting obscures losses resulting from unsuccessful exploration activities, when an otherwise comparable firm using successful efforts displays exploration failures (losses) in its financial reporting, then accounting has created the appearance of difference in the risks where none exists. The result, if that perception is correct, is an inequitable capital market and uneven and inequitable allocation of capital resources -- in effect, subsidizing the cost of capital to the full cost firms at the expense of their otherwise comparable successful efforts competitors.

Financial accounting should attempt to report the results of business decisions within an accepted framework of accounting applicable to all enterprises. If industry characteristics result in fluctuating earnings, financial reporting should reflect, not obscure, this characteristic. Similarly, if economic influences in another industry result in minor fluctuations, that too should be portrayed.

Oil and gas producing companies, of course, also compete in the capital markets with companies in other industries. The Board concluded that successful efforts costing was consistent with the presently accepted accounting framework followed in other industries, and that the full cost method of capitalizing exploration costs known not to have resulted in reserve discoveries was not. Again, in terms of perceived advantages enjoyed by certain full cost companies, a conclusion by the Board to accept existing alternatives would not have been even-handed, because it could contribute to subsidizing the cost of capital to some oil and gas producers at the expense not only of successful efforts competitors, but also companies in other industries competing for like capital resources.

The anticompetitive advantages in the capital markets enjoyed by some full cost companies were well expressed in the December 16, 1977 "Progress Report" of Statex Petroleum, Inc., a small independent producer using one of the many existing variations of successful efforts:

> "The FASB ordering statement entitled 'Financial Accounting and Reporting by Oil and Gas Producing Companies,' results in material changes in both the Company's reported financial position at October 31, 1976 and its results of operations for the fiscal year ended October 31, 1977. It will reduce Statex's retained earnings through October 31, 1976 by approximately $2,200,000 to $2,600,000. According to preliminary accounting studies just completed, the ruling's impact on 1977 operating results will move

the Company from an anticipated loss to a profit position and will reduce current year provisions for depreciation, depletion and amortization and abandonment expense.

* * *

"Despite the retained earnings write-down, it is estimated the Company's book value per share at the close of the 1977 fiscal year will be between $4.45 and $4.95 per share. The Company remains basically debt-free, therefore the write-down is not expected to have any significant effect on lender relations. Oil and gas reserves and cash flow will remain exactly as they were before the proposed accounting statement and although certain leasehold costs and other balance sheet items will be reduced or written off, the statement does not affect the future economic potential of the properties.

"Potential misunderstanding of the restatement lies not in the accounting changes themselves, but in the possibility that shareholders, investors, analysts and others might mistakenly equate the changes caused by the new accounting guidelines with actual events affecting the Company's fundamental values.

"Notwithstanding this possible misunderstanding for the short-term, one long-term benefit of the accounting changes will be to put all companies in the industry on a uniform accounting basis. This will facilitate comparisons and relieve companies such as Statex, which have used more conservative accounting methods, of the disadvantages of showing a less stable pattern of earnings than others whose accounting methods have been more liberal.

"The adoption throughout the industry of this uniform accounting practice allows investors and creditors to focus on earnings as an indicator of risks and returns."

3. <u>Uniformity Is the Paramount Issue</u>

The three issues being considered by the DOE - competition, energy supply, and energy data needs - are not separable but in reality constitute one paramount issue:

Whether a single accounting practice is to apply to oil and gas producing activities, or whether alternative, widely disparate, accounting practices should be permitted to continue.

Most full cost companies and their advisers are urging retention of the full cost method as an acceptable accounting alternative. Relatively few, on the other hand, most notably Arthur Andersen & Co., are urging both uniformity of accounting standards and the full cost method as that method.

This may be because those advocating full cost as an alternative believe that the perceived advantages full cost companies presently enjoy in the capital markets over successful efforts firms will be lost if either successful efforts or full cost is adopted as the single accounting method.

In all the circumstances, the Board believes it would be in the public interest, and in the best interests of the oil and gas producing industry, for the DOE, in commenting to the Commission, to support the adoption of a single accounting method, both for energy data and financial reporting purposes.

4. Full Cost as Subsidy or Incentive

Full cost advocates assert that the relatively stable and higher reported earning levels resulting from full cost's capitalization of all exploratory (including unsuccessful) costs is necessary if they are to continue to compete for capital at reasonable costs. To the extent that financial statements, particularly reported earnings, are important to

investment decisions, this position assumes, in effect, that financial statements minimizing exploratory failure (losses) and the risks inherent in oil and gas exploration are important to their capital raising and exploration efforts.

If, as it appears, full cost companies regard subsidies (substantially at the expense of independent successful efforts firms) as important to their ability to compete economically in the capital markets and to continue aggressive exploration programs, significant questions are posed:

- Should Government and energy policymakers consider the issues in policy terms and formulate and provide economic incentives - prices, taxes, and the like - designed to promote capital availability to all, and to encourage increased exploration by all competitors for new domestic supplies?
- Or should Government avoid the economic issues by manipulating financial accounting in hopes of a "quick fix", thus perpetuating the possibility of subsidies of some producers at the expense of others, as well as at the expense of other industries competing for capital resources?

Many argue that the full cost method is essential for an "aggressive" exploration program. A few full cost advocates concede, however, that the method might not result in a lower cost of capital than the successful efforts method would.

The use of the full cost method as a behavioral incentive raises even more significant issues than those related to the cost of capital. If, in the minds of some, it is necessary to account for an exploratory dry hole as an asset rather than as a loss in order to stimulate exploration, and if the DOE chooses to accept this argument (which has significant implications as discussed below), it must consider a number of difficult questions, including the following:

- If full costing is a behavioral incentive, should it be mandated for all companies?
- If it is mandated for all companies, does this result in fostering competition or does it increase the so-called advantage that some large companies already have?
- Should the incentive be granted selectively? For example, should it be available only to those managements which are defined in some way as "aggressive"?
- Should it be offered only to those companies that will explore in specified areas (geological - geographic?) consistent with defined policy goals? On the other hand, should those who explore in areas not consistent with defined policy goals be penalized by being prohibited from use of the full cost method? Can they switch back to full cost if they once lose it?
- Should the full cost method be available only to companies not already in the exploration business in order to stimulate new entrants?

The continued use of accounting alternatives certainly does not result in any controlled use of subsidy or of behavioral incentive. If the Department of Energy concludes that accounting should be used as an economic incentive (which the Board believes would be a very dangerous step), it is undertaking a very complicated and untried, and a truly inefficient means, of attempting to control and direct economic behavior.

Dr. John C. Burton, Professor of Accounting and Finance at the Columbia University Graduate School of Business and former Chief Accountant of the Commission and Deputy Mayor for Finance for the City of New York, summarized the policy issues, and the serious related implications to the capital markets, in his prepared testimony at the DOE hearings on February 21:

> "Finally, I would like to address myself briefly to the basic role of accounting in society. The basic social purpose of accounting is to supply information and unbiased measurement to all users of data. This purpose is extremely important since it is the cornerstone of the capital market allocation system. In the United States today we have a system which is generally agreed to be the best in the world and this is a major asset to the nation. Investment funds have flowed here from all over the world because of confidence in our markets and in the integrity of the data on which market judgments are based. If it is perceived that governmental policies are requiring that our basic measurement system be tampered with in order to serve purposes beyond economic measurement - such as energy production - we are taking a grave risk with a priceless asset which cannot be recovered once it is lost. Confidence once destroyed can only be rebuilt over a very long period of time.
>
> "Energy is a vital asset and increased production is an important national goal but it cannot be obtained

by adulterating the measurement system to encourage investors to commit funds. First, this approach will not work as is evidenced by the efficient market research which was described earlier. More importantly, the social costs of the attempt in terms of lost credibility in our public disclosure system and our capital markets will be enormous.

"Sometimes the arguments made for different accounting principles remind me of the athlete who had an X-ray of his damaged knee, and his doctor reported the X-ray showed that an operation costing $10,000 would be required. The patient's response was "I can't afford that. How much would it cost just to change the X-ray?" We can't obtain energy simply by changing accounting methods any more than we can heal knees by changing the X-ray. I urge the Department of Energy not to appear to be seeking such a result in its submission to the S.E.C. Even the appearance may result in high costs indeed."

The Board reached similar conclusions in its recent exposure draft entitled, "Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises".

B. Successful Efforts Is Preferable to Full Cost

The FASB concluded that successful efforts is preferable to the full cost method as the single accounting standard for oil and gas producers, as discussed in paragraphs 142-188 of Statement No. 19.

The Board's conclusions are sound, whether one considers the (1) economic characteristics of the oil and gas industry, (2) the nature of a mandated change to successful efforts (3) the economic evidence, or (4) compatability with the statutory requirements of EPCA, DOE Act or the Federal Securities Laws.

1. Economic Characteristics

Enterprises seeking capital operate in varying circumstances of possible success or failure. That is, they offer varying degrees of risk and opportunity to those supplying capital. While investors and lenders may differ among themselves with regard to risks they are willing to accept, one common denominator is that they seek a higher expected return for accepting higher risk. Business enterprises seeking capital offer different risks, and capital is most equitably allocated when returns are commensurate with the risk. Financial statements and financial data provide an important source of information on which investment, lending and related decisions are made.

The full cost method tends to obscure failure and risk, because it permits an enterprise to capitalize the cost of unsuccessful exploratory activities in one geological area, simply because that enterprise previously discovered valuable reserves in some other, unrelated geological area. In effect, full cost considers and treats "unsuccessful costs" as assets.

Successful efforts, on the other hand, highlights failure and the risks involved in the search for oil and gas reserves, by charging to expense those costs known not to have resulted in the discovery of reserves.

Neither the full cost nor successful efforts method reflects success at the time of discovery; under both, success is reported at the time of sale. However, the obscuring of failure, and thus risk, results only under the full cost method. Statement No. 19 reflects the Board's judgment that financial statements prepared on the successful efforts basis, with disclosure of capitalized costs and costs of production activities (to provide an indication of effort) and of oil and gas reserve quantities and reserve changes (to provide an indication of accomplishment), provides important information about success, as well as failure, and will provide investors, lenders, and Government policymakers with an important tool in assessing risks and returns in the oil and gas producing industry.* The Board did not find persuasive contentions that asset carrying amounts reported in full cost balance sheets would be closer to the current values of most companies' oil and gas reserves than if reflected under successful efforts, since costs to acquire, explore and develop are not intended to, and do not, indicate values of discovered reserves.**

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* Additionally, a proposal by the Commission in Securities Act Release No. 5878 (October 26, 1977) would, if adopted, provide for value-oriented data by requiring disclosure of the present value of estimated cash flows from future production of proved oil and gas reserves in filings with the Commission.

** Values change continually based on revised reserve estimates, development and production costs, taxes, timing of particular activities, selling prices and discount rates, and regulatory and Government determinations and policy.

The Board's determination to prescribe successful efforts as the single accounting method has been criticized on the grounds that past full cost earnings when restated will be reduced, and that ongoing earnings will fluctuate more than under full cost accounting, since earnings will reflect currently the risks, level and results of a company's exploration activities. While fluctuating earnings may indeed be a characteristic of successful efforts, it is not a fault. The Board found the focus of investors and creditors relying on financial statements to be principally on earnings - particularly earnings fluctuations - as an indication of risks and returns. The Board was not persuaded that managements would be more inclined under successful efforts to "smooth" earnings by delaying, or expediting, exploration; those possiblities are not unique to successful efforts but are inherent in the transaction-oriented accounting framework used by all companies in all industries. Full cost itself is a method of "averaging" reported earnings over long periods of time, as most of its advocates concede.

In the final analysis, the Board viewed the successful efforts method as providing the opportunity to observe and assess the impact of the risks inherent in oil and gas exploration activities, which, in the Board's judgment, is necessary if capital is to be allocated efficiently and equitably in a competitive market and if Government policy,

including price, tax or other incentives, is to be established on the basis of fact and necessity.

2. The Nature of a Mandated Change to Successful Efforts

A retroactive change in accounting to successful efforts may often be expected to result in reductions in previously reported earnings and, common with those companies already applying that method, fluctuating future earnings. In true economic terms, however, the change will not affect underlying economic facts or a company's intrinsic economic strengths. This is true whether considered in absolute terms or in relation to others competing in the marketplace.

This became apparent during the course of the Board's two years of study and evaluation. As one bank lending officer put it during the course of an interview in which he indicated that his decision-making process would not be materially affected by a change in accounting because "cash flow" data was more important, "You can't change economic facts by accounting entries."*

As a matter of economic fact, a mandated change to successful efforts as prescribed by Statement No. 19 will not affect or in any way change or alter, among other things, any company's

- revenues

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* See paragraph 90(a) of Statement No. 19.

- cash flows from oil and gas producing operations
- oil and gas reserves
- success or failure of exploratory or development activities, whether domestic, foreign or off-shore
- costs of exploration, development or production
- estimated costs of reserve additions
- cash requirements of exploration, development or production
- production of oil and gas
- prices at which oil and gas reserves could be sold if discovered and produced
- income taxes that become payable
- classification of information by function, whether domestic or foreign

The weight, by number, of those opposing Statement No. 19 at the DOE hearings and in their related written comments is consistent with the Board's general experience over the past five years. It is human nature that those opposing a proposal are the ones who appear at public hearings and submit written comments and retain consultants to prepare studies in an attempt to support their view. Conversely, the Board has found that those who favor and those who are willing to accept a proposal frequently neither appear at hearings nor continue to comment in writing.

The inevitable, though understandable, lack of balance imposes additional responsibilities on those assessing

testimony and written comments, and a corresponding responsibility to assess with care and objectivity such other data as is available but which may not have been contained in the testimony or related comments submitted in connection with the hearings. A healthy skepticism, and an awareness that those opposing proposals frequently have interests they wish to protect, can prove helpful.

The Board is an independent, recognized standard-setting body charged with acting solely in the public interest, that issued Statement No. 19 only after two years of concentrated study, review and evaluation of all interests, arguments and points of view. This alone imposes quite a burden on anyone seeking to reject or reform Statement No. 19, especially when the controversy in question has gone on continuously for 14 years. The Board has made available its public record, and other information and data generated over the years, to the DOE and the Commission, and commends it in the current consideration of Statement No. 19.

As Mr. Kirk noted in his testimony at the DOE hearings on February 21, the FASB staff has been reviewing, and will continue to review, public statements made by oil and gas producing companies concerning the impact of Statement No. 19. David Norr, one of those submitting written comments to the DOE, has provided the FASB with copies of his written submission in which Mr. Norr quotes a number of oil and gas

producing companies as stating in their recent public announcements and shareholder reports that a change to successful efforts as presented by Statement No. 19 will not affect their cash flow, the value of their oil and gas reserves, their exploratory programs, the declaration of dividends, or cause problems under their loan or other financing arrangements. Others have indicated that the effect of the change on previously reported earnings and retained earnings are non-cash charges, and some have noted, quite accurately, that a change to successful efforts will increase future earnings reported in respect of previously developed oil and gas reserves by reducing future depreciation, depletion and amortization charges.

For example, as one full cost company appearing at the DOE hearings stated in a recent shareholder report,

> "The Company wishes to emphasize strongly that the proposed change [to successful efforts] relates entirely to the _timing_ of charges against net earnings and has absolutely no bearing on the financial strength of the Company or the value of its assets." (Emphasis added.)

The same company put its finger on one of many managements' major concerns -- fluctuating reported earnings -- by pointing out that "the effect of the proposed change on future earnings is not predictable since it depends entirely on the results of the Company's exploration activities."

3. Additional Economic Evidence

The evidence before the FASB shows that many publicly-held oil and gas companies (see paragraph 161 of Statement No. 19), as well as a great many of the Independent Petroleum Association of America's estimated 10,000 privately-held exploration companies, prepare their financial statements on variations of the successful efforts method - and have been able to obtain capital from desired sources to finance their exploration activities. Additionally, most, if not substantially all, full cost companies use a variation of successful efforts accounting in determining their earnings for tax payment purposes.

It was not until the "go-go" years of the late 1960's and that era's preoccupation with reported earnings growth, that the full cost method became relatively widespread. Prior to that time virtually all companies raised capital for exploration activities employing successful efforts accounting.

The asserted effects of Statement No. 19 on previously reported full cost earnings and on retained earnings testified for at the DOE hearings demonstrate the degree to which financial and operating data can vary within a single industry when widely disparate accounting alternatives exist.

The Board considered economic consequences, including the effects on aspects of competition and energy supply, in various places throughout its 70-page Appendix B (paragraphs 97-269). The most concentrated discussion appears in paragraphs 157-174, including the additional paragraphs referred to in those paragraphs. The Board reached its conclusions on the basis of the extensive and comprehensive information and data made available or obtained by it. The Board also commissioned several supplementary research studies principally as a means of confirming other information and data.

One supplementary study, conducted by academic consultants, involved interviews with 24 loan officers of large and small banks that make loans to large and small oil and gas companies, bank and trust officers, securities underwriters of both large and small companies, security analysts and an officer of a bond-rating agency. A significant majority of those interviewed indicated that accounting and changes in accounting methods, and related effects on reported earnings, were either unimportant or of comparatively minor significance in their evaluations of oil and gas producers. The key factors most frequently cited were their own evaluations of oil and gas reserves and other assets and cash flow data. While some took into consideration the method of accounting when evaluating earnings, comparatively few believed that

reduced earnings from accounting changes might affect investors' decisions.* Those that did saw the less sophisticated ones being affected, which some thought could adversely affect, in the short run, some stock market prices.

Another supplementary study conducted by academic consultants involved a telephone interview survey of senior executive officers of 27 relatively small and medium-sized, publicly-held successful efforts companies. The purpose of the survey was to determine whether those interviewed thought that the use of successful efforts had had any negative effect on the ability of their companies to raise necessary capital for exploration and production activities. Not one of those surveyed indicated that successful efforts had hindered his company's ability to raise capital, although four did indicate uncertainty as to whether continued use of this method would affect their future capital-raising efforts.

The FASB also sponsored supplementary research studies by an academic consultant of the effect of the July Exposure Draft and final Statement No. 19 on the returns of

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* A letter dated February 10, 1978 from the investment banking firm of Warburg Paribas Becker to the Vice President-Finance of Natomas Company (Exhibit 1 to Natomas' outline of presentation to the DOE) advises that "the two principal bond rating agencies, Moody's and Standard & Poor's, have indicated that a change from full cost to the successful efforts method will not influence their credit ratings, as they look beyond accounting convention in their credit analysis."

full cost and successful efforts oil and gas producing companies' securities. Here again, none of these studies found statistically significant evidence that the issuance of either the Exposure Draft or the final Statement had affected the market prices of securities issued by full cost companies by comparison to those of the companies already on successful efforts -- excepting for some possible effect on the full cost companies for a brief period surrounding the issuance of those documents, but the studies found that the market soon adjusted and evidence of a permanent and lingering effect was not found.* Professor Dyckman, the author of these research reports, appeared as a witness at the DOE hearings to discuss his research and to be available to answer questions.

The Commission's Directorate of Economic and Policy Research conducted a similar study on the Exposure Draft entitled, "Full Cost vs. Successful Efforts: A Study of a Proposed Accounting Change's Competitive Impact," the results of which were released publicly on February 10, 1978. This

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* The FASB noted in paragraph 93(a) of Statement No. 19 that statistical testing of this type may not necessarily be conclusive, and in paragraph 171 that other research indicates that decisions of individual investors can be affected by accounting changes. The FASB did not regard its research studies as being pivotable or essential to its conclusions in Statement No. 19 or to the bases for its conclusions, but rather viewed these studies as supplementary to the already extensive information and data before it.

study found an initial adverse securities price impact for those oil and gas companies that would be subject to the accounting change as a result of the issuance of the Exposure Draft. However, the study also found a partial reversal of this initial impact, and it concluded that "a strong case can be made that most of the initial adverse impact traceable to the FASB Exposure Draft on the trading prices of [full cost] companies had been recovered." The Commission's study also concluded that "the evidence is weak in support of the [position] that [full cost] companies suffered a permanent impairment of their capital raising ability as a result of the announcement [of the Exposure Draft]."

On the energy supply issue, the Board was not presented with or able to obtain persuasive information indicating that adoption of successful efforts accounting and proscribing full costing would inhibit competition in the exploration for and production of oil and gas reserves or in financing those activities. The Board found that independent oil and gas producing companies using successful efforts had conducted and could continue to conduct effective exploration programs financed through a variety of capital sources.

A recent example of the vitality and aggressive operations of independent successful efforts producers appears in Sabine Corporation's letter to shareholders on February 2, 1978:

"Nineteen Seventy-Seven was another successful year for the Company. Both 1977 and 1976 contained gains aside from regular operations which benefited earnings. Excluding these special gains from both years, our earnings from regular operations in 1977 are projected to be about the same as the $2.08 per share earned in 1976. The full story for 1977 will be detailed in our annual report to be mailed in early March.

"The long-range commitment for increased emphasis on oil and gas exploration was discussed in last year's annual report. This commitment means higher costs and greater risk ventures, but the evidence indicates that the potential rewards are greater for such projects than in Sabine's traditional 'close-in' drilling exposures.

"Perhaps the best example of the impact this concept will have on Sabine's operations is seen in our exploration budget. Until recently, our exploration expenses seldom exceeded $6 million per year. In 1977, the total expense for all types of drilling was approximately $16 million. For 1978, we are planning for a drilling program of approximately $30 million. Future plans call for this program to increase, although at a more moderate rate.

"Obviously, these start-up expenses will put pressure on Company earnings growth for the near-term future. In candor, I must tell you that it is unlikely that Sabine will be able to maintain the rate of earnings growth of recent years and, in fact, because of the financial accounting rules that now require immediate expensing of most exploration costs, Sabine's reported earnings could show a modest decline in any given accounting period.

"However, just as Sabine is changing, we believe the way in which its success is evaluated over a given period of time will also change. Historically, Sabine's principal business was investments in oil and gas properties and earnings growth was the appropriate yardstick to measure growth. For the future, the ultimate strength of an energy company will be its energy reserves, with due consideration to its current operations as measured by current earnings.

"Hence, Sabine must operate in the future with greater emphasis on maintaining or increasing its reserves of oil and gas and other energy resources. This translates into more drilling expenses each year, and, statistically, this means more dry hole expense.

"All of this is, of course, building for the future. Sabine today has more and greater opportunities than at any time since I have been associated with the Company. It is clearly in the best interest of the Company and its shareholders to take maximum advantage of these opportunities. I need not remind you that reserves found today mean additional revenues in the future when those reserves are sold.

"Sabine moves into these new plans with the greatest financial strength in its 46 year history and a long record of shareholder participation in corporate profits. In this connection, the Board today declared a cash dividend of $.14 per share, payable March 14 to shareholders of record February 24.

"In closing, let me reiterate my view that Sabine has a bright, exciting future, playing a vital role in America's efforts to solve its energy problems. The capabilities of your management team have been proven by our growth to date. I have every confidence that this expertise, coupled with your continued support, will assure the long-range success of this new program."

While some full cost companies in commenting to the Board said that they would expect to reduce their exploration efforts because successful efforts accounting would reduce reported earnings, other full costing companies, as well as some appearing at the DOE hearings, have announced publicly that successful efforts accounting will not affect their exploration plans. For example, after issuance of the Exposure Draft, one company publicly stated at a meeting of security analysts that while a change to successful efforts would have a substantial effect on previously reported earnings, the change would not affect the value of its assets, its reserves, or its cash flow, and that it had decided not to change its exploration program if the accounting contained in the Exposure Draft were required.

Some commentators to the Board claimed that full cost accounting is essential to the viability of companies in the start-up or development stage, because investors and lenders would be disinclined to provide capital if the financial statements of these comparatively new entrants were to report net operating losses or cumulative deficits.

It is not clear how initial losses should be treated under the full cost method. Most proponents of the method indicate that the reserve value "cover" on capitalized costs is an essential condition for use of that method. Except for those fortunate few new companies that find relatively large quantities of proved reserves in their initial exploration efforts or that purchase interests in proved properties, it seems likely that most new exploration companies would be reporting operating losses and cumulative deficits regardless of whether on full cost or successful efforts accounting. In any event, the weight of the evidence before the Board was that most security analysts and lending officers viewed oil and gas reserves, cash flows, and exploratory successes and prospects as the principal basis for their investment and credit decisions.

This evidence is consistent with evidence available to the Board in an analogous situation when it issued Statement No. 7, "Accounting and Reporting by Development Stage Companies." There the Board, based on a survey of 15 suppliers of venture capital, found that capital suppliers to companies in the start-up or development stage understood the special circumstances of these companies and the possibility that their financial statements would report losses and deficits. Those surveyed stated that whether those enterprises deferred or expensed costs had little effect on the

amount of the venture capital provided to the enterprise or the terms under which it was provided.

This survey and the Board's economic conclusions in Statement No. 7 received independent support in a study conducted by the U.S. Department of Commerce on the effect of FASB Statement No. 2 (which establishes a single accounting method by requiring expensing, and prohibiting capitalizing, research and development costs) on small, development stage companies. The study's focus was on the impact of investment and credit decisions concerning development stage enterprises if they were required to charge research and development costs to expense when incurred. The study concluded that "FASB's Statement Two should not have a significant impact on those firms who have heretofore capitalized R & D."*

Similarly, some advocates of full cost have asserted that the Federal Power Commission adopted full cost for natural gas companies in its Order No. 440 (November 1971) in order to stimulate the search for and development of new natural gas supplies. This is incorrect, and the implication that successful efforts will impede exploration, development and

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* U.S. Department of Commerce, "Impact of FASB's Rule Two Accounting for Research and Development Costs on Small/ Developing Stage Firms," page 3 (January 20, 1975). The study interviewed 40 lenders and investors, 11 small technology firms, 11 accountants and selected Government agencies.

production has no support by reason of the FPC's action. In Order No. 440-A (January 5, 1972), the FPC denied a petition for rehearing of Order 440 stating: "Since we concluded that full-cost accounting on its merits should be adopted [for rate-making purposes for natural gas companies under FPC jurisdiction], it is not necessary for us to proceed further and reach a finding as to whether the accounting, as such, would provide a stimulus to discover and develop new gas supplies."

The Board is aware that some have expressed concerns that successful efforts accounting may tend to inhibit entry into gas and oil exploration by large industrial or conglomerate concerns seeking to diversify into exploration with excess funds generated in their unrelated operations. Among those commenting on the July Exposure Draft were companies mainly in other lines of business but that either had, or had under consideration, oil and gas exploration subsidiaries or divisions. Those respondents urged retention of full cost for the oil and gas exploration activities, on the grounds that investors and lenders do not regard the enterprise generally as an oil and gas producing company and, thus, would not understand fluctuations of purported earnings that would most likely result from using successful efforts. The Board concluded that this was not an appropriate reason for permitting adopton or continuation of full cost. Accounting

standards should not be designed to make the earnings patterns of an oil and gas exploration operation look like a public utility with a regulated rate of return, or like a stable industrial company. On the other hand, when a company considers oil and gas exploration, its financial statements should reflect the economics of diversification, not minimize or obscure it.

If capital subsidies and behavioral incentives should be desirable, they should be considered and extended selectively and only where needed to accomplish a policy objective - not on an across-the-board basis where windfalls may result or where those needing benefits may end up as the subsidizers.

4. Compatability with Objectives of Energy Legislation

One of the purposes of EPCA, as stated in Section 2 of that Act, is "to provide a means for verification of energy data to assure the reliability of energy data." The accounting practices to be developed pursuant to EPCA are "for purposes of developing a reliable energy data base related to the production of crude oil and natural gas." One of the purposes of the DOE Act is to "continue and improve the effectiveness and objectivity of a central energy data collection and analysis program."

Section 503 of EPCA requires that such accounting practices must, to the greatest extent practicable, permit

the compilation of an energy data base with separate calculation of capital, revenue, and, significantly, operating cost information pertaining to prospecting, acquisition, exploration, development, and production activities. Moreover, these accounting practices must, to the greatest extent practicable, permit the full presentation of financial information, including disclosure of reserves and operating activities, both domestic and foreign, to facilitate evaluation of financial effort and result. Section 205(h)(3) of the DOE Act requires the Administrator of the Energy Information Administration to consult with the Chairman of the Commission with respect to the development of accounting practices required by EPCA, with a view to assuring that the Section 205(h)(2) energy-producing company financial report (requiring reporting on a uniform and standardized basis), is, to the extent practicable and consistent with the DOE Act, consistent with the accounting practices to be developed under EPCA where applicable.

The data required to be developed through formulation of accounting practices mandated by Section 503 of EPCA involve accounting measurement standards of the type over which the FASB has authority in the preparation of general purpose financial statements. For example, Section 503 requires these accounting practices to address such issues as revenue and cost recognition, disposition of capitalized

costs, accounting for contractual arrangements involving special conveyance of rights and joint operations, and differences between book and tax income.

It is clear that the successful efforts method prescribed by Statement No. 19 is compatible with the objectives of EPCA and the DOE Act, including the proposed petroleum company financial reporting system, no one has presented evidence that it is not. Indeed, in view of the requirements of "uniformity and standardization" and the "separate calculations" of operating and other costs by function and the lines of commerce, geographic area, unsuccessful exploratory drilling costs -- all with a view to facilitating evaluation of financial effort and results -- a case may be made that successful efforts will prove more appropriate than full cost as the accounting practice to be developed in connection with the DOE's energy data base. With the focus these requirements have on "costs", it seems doubtful that value based alternatives would be feasible.

A single accounting method makes the aggregation of accounting information into a useful data base more feasible. If each company's results must be adjusted in achieving industry consistency and comparability, the task of developing energy data for a useful energy data base will be many times more difficult and costly. While it may be theoretically possible

to mandate one accounting practice for purposes of energy data collection and to permit oil and gas producers to utilize another method or alternatives for reporting to investors, this would entail the maintenance of additional records and increase economic costs both to them and ultimately to consumers. These burdens would be particularly severe for small independent producers, which are on record as opposing unnecessary regulatory reporting.

As discussed above, a change to successful efforts will not change or affect the underlying economic realities and facts on which financial information will be collected or reported to the DOE.

In addition to the liaison between the FASB, the FEA, and the DOE over the past two years as discussed above (see also paragraphs 79, 85 and 92 of Statement No. 19), the Commission, as required by EPCA, has consulted with the FEA and DOE with respect to EPCA. The DOE has advised the Commission that it plans to meet its data-gathering responsibilities under EPCA with its petroleum company financial reporting system. The FASB understands that the instructions to the FRS will require that the data reported relating to oil and gas producing activities be compiled and reported in accordance with accounting practices prescribed by the Commission.

The FEA held a public panel discussion on the FRS on July 29, 1977 and written comments pertaining to the proposed implementation of the FRS were received. Subsequently, major revisions to the proposed system were made, and the Commission staff has discussed these revisions with the staff of the DOE and received drafts of the proposed revised forms. The FRS will involve both annual and quarterly reports.

The Commission has coordinated and is coordinating its efforts with regard to EPCA with the DOE's continuing efforts to develop the FRS. The Commission indicated in Securities Act Release No. 5877 (October 26, 1977) that based on the current status of the FRS, the Commission viewed its proposed accounting and disclosure rules, including its proposals with respect to Statement No. 19, as being consistent with the oil and gas production reporting requirements proposed by the DOE.

In Release No. 5877 the Commission also stated that since the basis of reporting to the DOE is essentially the same as reporting to investors and that uniformity was desirable, it did not consider the separation of issues related to DOE reporting and investor reporting to be practicable or consistent with the Commission's statutory responsibilities.

The Board believes that determination of whether the accounting and reporting standards in Statement No. 19 are appropriate for the purpose of reporting information to the Department of Energy pursuant to EPCA must be made by the Commission, after consultation with the Department of Energy, and the other Federal Government agencies named in Section 503 of EPCA. In the judgment of the FASB, Statement No. 19 provides a sound framework within which a national energy data base can be developed by the Department of Energy and provides the Commission with accounting practices on which it may reasonably rely in meeting its obligations under Section 503 of EPCA.

V. CONSIDERATION OF COMPETITIVE EFFECTS

As a result of the the Securities Acts Amendments in 1975, Section 23(a)(2) of the Securities Exchange Act of 1934 requires the Commission to consider in its rulemaking, among other matters, the impact its rules and regulations might have on competition, and prohibits the Commission from adopting any rule or regulation which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the 1934 Act.

If Section 23(a)(2) applies here and assuming (contrary to the weight of the evidence the Board found

persuasive) that successful efforts as such could impose an anticompetitive burden for some producers, the Board believes that Statement No. 19 can nevertheless reasonably be supported by Government, and the Commission may reasonably adopt its oil and gas rule proposals and determine to rely on Statement No. 19 in meeting its statutory obligations.

On its face Section 23(a)(2) does not require that the Commission take the least anti-competitive approach in performing its regulatory functions under the Federal Securities Laws. That this was intentional is quite clear from the legislative history.

During February 1975 hearings before the Subcommittee on Securities of the Senate Banking, Housing and Urban Affairs Committee on the proposed Amendments, the Department of Justice recommended that Section 23(a)(2) be amended to incorporate a "least anti-competitive" standard. The Justice Department recommended that then proposed Section 23(a)(2) be amended as follows:

> "The Commission shall, in making rules and regulations or issuing orders pursuant to any provision of this title, consider among other matters the impact any such rule [or] regulation or order would have on competition. The Commission shall [not adopt any such rule or regulation which would impose a burden on competition] remove any burden on competition not necessary or appropriate in furtherance of the purposes of this title and in all cases adopt the least anti-competitive means of protecting investors and preserving fair and orderly markets in securities. (Pick up balance of paragraph (2))." Securities Acts Amendments of 1975;

Hearings on S.249 before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 1st Sess., 261 (1975) (statement of Donald I. Baker, Deputy Assistant Attorney General, Antitrust Division, Department of Justice). (brackets and underscoring in original)

The Department's recommended amendment was not adopted.

The Senate Report indicates the intent of the 1975 Amendments, including Congress' rejection of the "least anti-competitive" standard for Commission rule-making:

> "This explicit obligation to balance, against other regulatory criteria and considerations, the competitive implications of self-regulatory and Commission action should not be viewed as requiring the Commission to justify that such actions be the least anti-competitive manner of achieving a regulatory objective. Rather, the Commission's obligation is to weigh competitive impact in reaching regulatory conclusions. The manner in which it does so is to be subjected to judicial scrutiny upon review in the same fashion as are other Commission determinations, with no less deference to the Commission's expertise than is the case in other matters subject to its jurisdiction." S. Rep. No. 94-75, 94th Cong., 1st Sess., 13 (1975). (Emphasis added.)

The Senate report continues that the effects on competition are merely one factor to be balanced by the Commission in reaching its determinations:

> ". . . Section 23(a) would require the Commission to evaluate its own regulatory proposals in light of the fundamental national economic policy of furthering competition and would prohibit it from promulgating any rule which the Commission determines will impose a burden on competition not necessary or appropriate to achieve the purposes of the Exchange Act. Under all of these Sections, the Commission's responsibility would be to balance the perceived anti-competitive effects of the regulatory policy or decision at issue against the purposes of the Exchange Act that would be advanced thereby

and the costs of doing so. Competition would not thereby become paramount to the great purposes of the Exchange Act, but the need for and effectiveness of regulatory actions in achieving those purposes would have to be weighed against any detrimental impact on competition." *Id.* at 13-14. (Emphasis added.)

Some have suggested that Statement No. 19 could have an adverse effect on "competition" because it could adversely affect the ability of certain individual companies to compete. However, the Board does not understand that the policy of "competition" necessarily carries with it the necessity of preserving all "competitors."

The oil and gas producing industry cannot be viewed solely in terms of a few very large integrated international companies. A 1977 list of publicly-owned companies registered with the Commission identifies 214 companies in the "petroleum and natural gas extraction" Standard Industrial Classification, not one of which is a "major", integrated oil and gas company. A representative of the Independent Petroleum Association of America estimated at the Board's 1977 oil and gas public hearings that there were 10,000 privately-owned exploration companies. Additionally, a number of companies that are mainly in other lines of business have oil and gas exploration subsidiaries or divisions. While the financial and economic strengths of the major international integrated companies are sizeable, the number of other publicly-owned companies and the vast number of privately-owned enterprises is impressive and an indication of the exploration going on.

Extending or permitting hidden capital subsidies and providing behavioral incentives to some through accounting, when others prefer to track current operating performance by keeping records based on successful efforts and others are unwilling, or unable, to maintain special books when they keep successful efforts records for tax purposes and use tax records in obtaining financing, hardly seems to be the equitable or most effective way of providing subsidies and incentives. If subsidies and incentives are viewed as necessary policy, the objectives will not be realized without careful selectivity based on defined criteria responsive to necessity and the objectives themselves.

A case in point is the elimination of fixed commissions in the heavily populated brokerage industry in 1975 by the Commission, with the support of the Department of Justice. This was mandated to foster competition in that industry, notwithstanding the fact that it was conceded that a number of firms might be forced to merge, reduce their level of operations, or go out of business altogether. The Department of Justice, in its comments on the Commission's proposals to eliminate fixed commissions, indicated that adverse effects on the businesses of certain competitors was perfectly consistent with fostering

competition in the absence of a significant adverse impact generally:

> "There is no evidence that the demise or merger of 50, 100 or 150 of the many NYSE member firms would have any significant impact on the Commission's ability to afford investor protection or maintain fair and orderly markets. The needed modernization of the securities industry with a regard for reducing costs of operation can occur most effectively in an environment of competitive rates. Less efficient firms should not be subsidized at the investing public's expense, by an increased fixed commission rate. Rather, such firms should be encouraged to strengthen their operations, to leave the industry, or to arrange mergers which do not unduly increase concentration in the industry. All three alternatives are presently available." Comments of Thomas E. Kauper, Assistant Attorney General, Antitrust Division, to the SEC on SEC File No. 4-167, Hearings on Commission Rate Schedules of Registered National Securities Exchanges, dated August 10, 1973. (Emphasis added.)

VI. CONCLUSION

The Financial Accounting Standards Board completed its project on "Financial Accounting and Reporting by Oil and Gas Producing Companies" in December 1977, thereby fulfilling its various responsibilities.

The burden of those seeking to reject or reform the conclusions of Statement No. 19 is a substantial one.

The Financial Accounting Standards Board hopes that the Department of Energy will be supportive of Statement No. 19 in any position that it might take in commenting to the Securities and Exchange Commission.

Respectfully Submitted,

FINANCIAL ACCOUNTING STANDARDS BOARD

TESTIMONY
OF
DONALD J. KIRK
CHAIRMAN,
FINANCIAL ACCOUNTING STANDARDS BOARD

PUBLIC HEARINGS
OF
DEPARTMENT OF ENERGY

TO CONSIDER
FASB STATEMENT NO. 19,
"FINANCIAL ACCOUNTING AND REPORTING
BY OIL AND GAS PRODUCING COMPANIES"

February 21, 1978

I am Donald J. Kirk, Chairman of the Financial Accounting Standards Board. Given those in attendance today and the subject of these hearings, there is no need for me to dwell on what the FASB is or does. Suffice it to say that the Board is an independent body recognized by the AICPA and the SEC as the private sector's authoritative body for establishing financial accounting and reporting standards. With SEC oversight, those standards are presumptively binding for the purposes of the Federal Securities Laws. Congress has also recognized the competency and authority of the Financial Accounting Standards Board, as demonstrated by Section 503 of the Energy Policy and Conservation Act and in the recent report of the Metcalf Senate Subcommittee.

I am pleased to have this opportunity to discuss the principal conclusions reached by the FASB in its Statement No. 19, "Financial Accounting and Reporting by Oil and Gas Producing Companies," which we

issued on December 5, 1977 after two years of hard work. I view my participation today as another step in the continuing liaison and cooperation over the past two years between the Department of Energy and the FASB. This has been significant to the development of Statement No. 19's accounting standards and, to my way of thinking, the Department of Energy's energy data base, too.

In terms of the purpose of these hearings, the Board spent a great deal of time considering extensive information and data with respect to possible economic consequences of Statement No. 19, including aspects of competition and energy supply, and the appropriateness of Statement No. 19 to the DOE's financial reporting system. We reached conclusions on those matters on the basis of our two years of proceedings, as well as our assessment of the record of the efforts of the Accounting Principles Board from 1970 to 1973, and a great deal of additional data developed on the successful efforts/full cost controversy over the past thirteen years.

Very briefly, let me summarize what the FASB concluded in Statement No. 19 and its assessment and conclusions on economic consequences. I might add that our formal response to the Department of Energy's Notice of Inquiry discusses these matters in far greater detail, including the reasoning that led us to conclude as we did.

Statement No. 19 prescribes a single uniform accounting method for all companies engaged in oil and gas producing activities by requiring a form of "successful efforts" accounting to be adopted retroactively for

costs incurred in exploring for and developing oil and gas reserves. Specifically, Statement No. 19 requires, among other things, that exploration costs that do not result in discovery of oil and gas reserves be charged to expense. Statement No. 19 also proscribes the myriad of presently acceptable "free choice" accounting alternatives, including numerous variations of both the successful efforts and "full cost" methods, that have affected the reliability, comparability, and utility--and thus the credibility--of financial reporting by oil and gas producers for years. Finally, to provide information about success as well as failure, Statement No. 19 requires disclosure of capitalized costs and costs incurred in oil and gas producing activities (to provide an indication of effort) and of reserve quantities and changes in reserves (to provide an indication of accomplishment). The SEC's August and October 1977 proposals, which rely on the work of the FASB, also propose disclosure of additional information on the present value of estimated cash flow from future production of proved reserves.

Three of the FASB's seven members dissented on Statement No. 19 for various technical reasons. However, all members, including those dissenting, rejected the full cost method by which costs of exploration efforts in a geological area in which no reserves are found are capitalized simply because the company previously discovered valuable reserves in an unrelated geological area.

The Board concluded that a principal defect of full cost is that it tends to obscure risk and failure of unsuccessful exploratory activities. Successful efforts highlights those failures and the risks inherent in oil and gas exploration by charging currently to expense costs known not to

have resulted in reserve discoveries. By contrast, full cost considers those unsuccessful costs to be assets.

In prescribing successful efforts as the uniform accounting method for oil and gas producers, the FASB assessed and reached conclusions on possible economic consequences, including possible adverse effects on aspects of competition and energy supply. In brief, the Board concluded that the evidence was not persuasive as to possible adverse effects, either generally or for small, independent producers, including those in the development or start-up stages. Quite to the contrary, the Board found that the weight of evidence was that independent oil and gas producers using the successful efforts method can and do compete successfully and conduct effective exploration and productive programs that they are able to finance through a variety of capital sources.

I should add at this point that most of the major publicly held oil and gas companies, over 40 percent of the smaller publicly held companies, and an overwhelming number of the privately held companies prepare their financial statements on the successful efforts method; they have done so for many years; and most if not virtually all companies, including full cost companies, use a form of successful efforts in their tax accounting. On the other hand, it was not until the late 1960's that the use of full cost became relatively widespread.

The Board further concluded that Statement No. 19 will foster competition in the capital markets and in the allocation of capital resources.

Finally, the Board believes that Statement No. 19 provides a sound framework within which a national energy data base can be developed by the DOE, and provides the SEC with accounting practices on which it may reasonably rely in meeting its obligations under Section 503 of EPCA and under the Federal Securities Laws.

As I mentioned earlier, the FASB issued Statement No. 19 only after over two years of considering the issues and gathering, reviewing, and evaluating all available information and data. The Board's "due process" procedures exceed those required by the Administrative Procedures Act and permitted all those who wished to participate to do so in our four days of public hearings and by written comments on our December 1976 Discussion Memorandum and the July 1977 Exposure Draft.

Let me summarize some of the Board's reasoning in concluding that a uniform accounting method -- the successful efforts method -- best meets the needs of investors and will promote formulation of the energy data base.

Different accounting for the same facts and circumstances impedes comparability and consistency of financial statements and significantly detracts from their usefulness. The Board concluded that the facts and circumstances surrounding the search for and development of production of oil and gas are essentially the same regardless of the size of a company or whether its securities are publicly traded. The Board further concluded that, far from being anti-competitive, mandating one

accounting method will eliminate the burdens of inconsistency, non-comparability, and misunderstanding in the capital markets and will foster competition in capital allocation by having all oil and gas producers reporting comparable data, reflecting the risks inherent in exploration as objectively and evenhandedly as possible.

Those advocates of the full cost method who allege that their access to capital will be adversely affected by Statement No. 19 evidently perceive a present competitive advantage in the capital markets over their successful efforts competitors. To the extent that this advantage results from the fact that full cost accounting obscures losses from unsuccessful exploration activities, when an otherwise comparable firm using successful efforts displays exploration failures and losses in its financial statements, then financial reporting has created an apparent difference in the risks where none exists. The result is an anti-competitive capital market and uneven and inequitable allocation of capital resources -- in effect, subsidizing the cost of capital to the full cost firms at the expense of their otherwise comparable successful efforts competitors.

This advantage for some full cost companies is by no means theoretical; it has been discussed in the stockholder communications of some companies.

With regard to energy supply, the Board was not presented nor was it able to obtain persuasive evidence supporting the assertion that adoption of successful efforts and proscription of full cost would

inhibit competition in the exploration, development and production of oil and gas. The weight of the evidence before the FASB was that many indpendent oil and gas producing companies using successful efforts accounting can and do compete successfully; they conduct effective exploration and production programs; and they are able to finance through a variety of capital sources. The accounting change to successful efforts prescribed by Statement No. 19 has no effect on, and in no way alters, any company's cash flow; the value of its oil and gas reserves; its costs of exploration, development, or production; oil and gas pricing or other marketplace characteristics; the success or failure of exploratory or development activities including prospects of finding commercially recoverable reserves; or a company's income tax payments. The Board concluded that a change to Statement No. 19's successful efforts method will not adversely effect the ability of companies to raise capital needed in the search for new energy supplies.

While a change to Statement No. 19's successful efforts method may in the short run reduce earnings and retained earnings reported in the financial statements, perhaps significantly, the weight of the evidence was that while financial statements provide useful data, investors, lenders, and other suppliers of capital make their investment and credit decisions principally on analysis of a company's exploration track record, its oil and gas reserve position, and its cash flow. The evidence with respect to new companies in the start-up or development stage is that whether these new companies defer costs or expense them has little effect on the amount of venture capital provided them or the terms under which it is provided.

The Board has considered, and rejected at this time, value accounting for oil and gas reserves. Even the two dissenters who viewed value accounting as ultimately a preferable solution conceded that this was not the time to change to a new accounting measurement basis from historical cost. Apart from concluding not to adopt current value accounting at this time in the narrow context of the oil and gas industry, the Board's recent hearings in its conceptual framework project have indicated clearly that a great deal of work must be done including experimentation, before current value accounting could, if ever, replace the historical cost system, whether in general or in specific cases. Further, the recent SEC proposal that contemplates supplementary disclosure of discounted present value of cash flow from future production of proved reserves can be viewed as a means of providing some value oriented information.

I am confident that on assessment of the entire record the DOE will agree with the Board that Statement No. 19 provides a sound framework within which the energy data base may be compiled and that Statement No. 19 will not adversely effect competition or energy supply.

Thank you again for the opportunity to appear today.