What you need to know

- Oil and gas entities may need to consider whether recent declines in oil and natural gas prices create accounting risks, such as counterparty credit risk, impairment risk or going concern risk.

- Other entities that do business with entities in the oil and gas industry, particularly suppliers, customers and lenders, may need to consider accounting risks, especially those associated with credit risk and impairment.

- Entities that report on internal control over financial reporting also may need to consider whether their existing processes and controls are sufficiently precise to identify and mitigate risks posed by lower oil and natural gas prices.

Overview

Recent declines in worldwide crude oil and natural gas prices may create a number of accounting and disclosure implications for oil and gas entities. It may also have an indirect effect on their suppliers, customers, lenders and others that directly or indirectly rely on or do business with entities in the oil and gas industry.

The outlook for prices in 2020 and beyond remains uncertain, due to factors that include:

- The lack of an agreement on production levels by members of the Organization of the Petroleum Exporting Countries (OPEC) and other oil- and gas-producing countries, which could result in production outstripping demand.
The effects of the coronavirus (COVID-19) outbreak, which has decreased demand for oil and gas products and services as companies and other organizations around the world have suspended or curtailed operations and travel.

Uncertainty about the future demand of oil and natural gas that predates the coronavirus outbreak due to factors such as the transition toward cleaner energy.

Considerations for oil and gas entities

Depending on their facts and circumstances, oil and gas entities may need to consider how recent declines in oil and gas prices could affect their accounting in the following risk areas.

Revenue recognition

Declines in crude oil and natural gas prices could affect revenue estimates in new and ongoing customer contracts in the scope of Accounting Standards Codification (ASC) 606, Revenue from Contracts with Customers. This will be a concern particularly for oilfield service, midstream and logistics entities that have revenue contracts with upstream entities. This is because when a contract with a customer includes variable consideration (e.g., discounts, refunds, price concessions, performance bonuses and penalties), an entity is generally required to estimate, at contract inception, the amount of consideration to which it will be entitled in exchange for transferring promised goods or services. The amount of variable consideration an entity can include in the transaction price is constrained to the amount for which it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainties related to the variability are resolved.

An entity that makes such an estimate is also required to update the estimate throughout the term of the contract to depict conditions that exist at each reporting date. This will involve updating the estimate of variable consideration (including any amounts that are constrained) to reflect an entity’s revised expectations about the amount of consideration to which it expects to be entitled.

Declines in prices could also prompt entities to modify contracts with customers or reassess whether it is probable that the entity will collect the consideration to which it is entitled. If both parties to a contract agree to amend the scope or price (or both) of a contract, an entity should account for the modification under the guidance in ASC 606-10-25-10 through 25-13. Significant judgment is required to determine when an expected partial payment indicates that (1) there is an implied price concession to be accounted for as variable consideration, (2) there is an impairment loss (see Financing receivables and contract assets below) or (3) the arrangement lacks sufficient substance to be considered a contract under the standard.

Financing receivables and contract assets

Oilfield service, midstream and logistics entities should challenge the appropriateness of their allowances for financing receivables and contract assets, with a particular focus on receivables from upstream entities. Upstream entities may also need to consider credit risk in any joint interest billing (JIB) arrangements and the realizability of JIB receivables.

Companies applying ASC 326, Financial Instruments – Credit Losses, are required to consider reasonable and supportable forecasts of future economic conditions in the estimate of expected credit losses. Affected companies that apply ASC 326 will need to consider whether recent declines in oil and gas prices should change their forecast of future economic conditions. In particular, they should consider whether there is an increase in the probability that borrowers may be unable to repay their obligations when due. While forecasted economic conditions may not significantly affect loss estimates for short-term receivables and contract assets when the economy is stable, we believe affected entities may need to challenge these assumptions in the current environment.
ASC 326 requires companies to pool financial assets based on similar risk characteristics but allows them to choose which risk characteristics to use. Affected companies may need to assess whether assets in pools continue to display similar risk characteristics or determine whether they need to revise their pools or perform an individual assessment of expected credit losses.

There are uncertainties about what the effects of the recent declines in oil and natural gas prices will ultimately be. Entities should consider highlighting these risks in their qualitative and quantitative disclosures about credit risk and the allowance for credit losses.

Inventory valuation
Weak demand for oil and natural gas may trigger the need for a lower of cost and net realizable value test (or lower of cost and market test for inventory measured using the last-in, first-out method or the retail inventory method) for crude oil, natural gas and other commodity inventories. This also includes other commodity inventories whose value generally moves in the same direction as crude or natural gas prices (e.g., transportation fuels, natural gas liquids). Firm purchase commitments should be included in this analysis. Inventory that has been designated as the hedged item in a fair value hedge would be assessed for impairment after hedge accounting has been applied for the period.

Impairment analyses
Entities may need to analyze whether long-lived assets, equity method investments, goodwill and other intangible assets are impaired using the model prescribed by applicable US GAAP. In some cases, they may need to revise the useful lives of certain assets.

Impairment indicators may exist, especially for oil and gas properties and oilfield services-related equipment. Recent declines in prices could affect producers’ impairment or ceiling test analyses of oil and gas properties under the successful efforts method or the full cost method, respectively. Oilfield services entities may find that cancellations or delays in development plans of their customers mean that equipment carrying amounts may not be recoverable because of reductions in rates and current and future utilization. Midstream and downstream entities also may be affected by changes in a producer’s drilling plans.

An entity should carefully evaluate the appropriateness of inputs and assumptions, especially long-term price and volume forecasts that are used to develop prospective financial information for these impairment analyses. If an entity narrowly avoids recording an impairment based on its analysis, management should consider the sensitivity of its analysis to various assumptions and evaluate corroborating and contrary evidence that is reasonably available and make appropriate disclosures.

How we see it
Entities should consider whether inputs and assumptions used in an impairment analysis are consistent with those used for other purposes, such as presentations to the board of directors, budgeting and forecasting. In addition, discount rates should reflect the level of uncertainty associated with pricing or other assumptions (e.g., growth, volume) inherent in the projected financial information.

Oil and gas reserves (including effects on depreciation and impairment)
The recent declines in oil and gas prices could affect reserve reporting and disclosure, particularly for proved undeveloped reserves (PUDs). If material PUDs are derecognized or proved reserves are otherwise significantly reduced, an entity should consider the effects on depreciation, depletion and amortization rates and impairment analyses. We understand that the Securities and Exchange Commission (SEC) staff expects PUDs to be recognized only when there is reasonable certainty about the geological data, management’s final investment decision about its development plans and the availability of financing to perform the development activities, among other things.
Oil and gas entities should challenge whether their PUDs continue to meet these and other PUD recognition criteria in the current environment, particularly when there are changes in their ability to obtain any necessary financing. This evaluation includes challenging whether counterparties (e.g., joint interest owners) are reasonably certain to be able to provide financing when the development of reserves depends on that financing. This evaluation could lead to the derecognition of PUDs.

Similarly, an entity should reconsider its assumptions about the production life of proved developed reserves (e.g., an entity’s expectations for when the wells cease to be economic).

In addition, the supplemental oil and gas information disclosure for public upstream entities is also likely to be significantly affected by the recent declines in prices because the SEC’s Rule 4-10(a)(22)(v) of Regulation S-X requires the use of a 12-month average price for proved reserve estimates.

### Disposals and assets held for sale

Entities that have decided to dispose of an asset group should consider whether it meets the criteria for recognition as an asset held for sale. Additionally, entities should monitor whether assets that were previously classified as held for sale continue to meet the held-for-sale recognition criteria, given the current economic environment. Assets held for use are subject to a recoverability test based on undiscounted cash flows using entity-specific assumptions and are impaired only if the entity determines that the carrying value is not recoverable. Assets held for sale are carried at the lower of carrying value or fair value less costs to sell (if that is less than the carrying value of the asset group) using market participant assumptions. Entities should carefully consider inputs and assumptions, including contrary evidence, when estimating the fair value of a disposal group.

If the held-for-sale criteria are met or the asset group has been disposed of, the entity also needs to assess whether the asset group qualifies for treatment as a discontinued operation in accordance with ASC 205-20, Presentation of Financial Statements – Discontinued Operations.

### Asset retirement obligations

Changes in estimates of proved reserves and drilling plans, as well as the effect of pricing pressure on support services, may affect the timing, amount and probabilities of expected cash flows associated with plugging wells or retiring other long-lived assets. This added uncertainty could affect the accounting for asset retirement obligations. For example, near-term costs may be reduced in periods of lower oil and gas prices, while longer-term costs may be expected to rise if and when oil and gas prices recover. Changes in the certainty of the cash flows may lead to changes in probabilities assigned to expected cash flow scenarios or to adjustments of the market risk premium when estimating asset retirement obligations.

### Derivatives and hedging activities

Entities with derivative instruments may experience substantial gains or losses on these instruments, which could affect collateral requirements and liquidity. In addition, entities need to consider the effect of ongoing price volatility in determining whether their hedging relationships continue to be highly effective. This is particularly relevant in situations where there is a basis difference between the hedging instrument and the hedged item. Changes in a derivative counterparty’s credit risk or an entity’s own non-performance risk also could affect fair value estimates of derivatives and hedge effectiveness. Mergers and acquisitions or disposals of businesses could result in changes to derivative counterparties, called novations, which also could affect derivative valuations.

Entities that apply cash flow hedge accounting also need to assess whether it is still probable that the hedged forecasted transaction will occur. If it is no longer probable that the hedged forecasted transaction will occur, the hedge is de-designated, and any future changes in the
The fair value of the hedging derivative would be reported directly in earnings. In addition, if an entity determines that it is probable that the forecasted transaction will not occur within the specified time period (or within an additional two-month period thereafter), it has to immediately reclassify to earnings balances from past changes in the fair value of derivative contracts that have been recorded in accumulated other comprehensive income (AOCI).

Generally, amounts in AOCI are reclassified into earnings when the forecasted transaction affects earnings. However, if an impairment loss is recognized on an asset to which a hedged forecasted transaction relates (e.g., the forecasted sale of inventory), earnings are affected before the actual forecasted transaction occurs. In these circumstances, some or all of the amounts deferred in AOCI from the cash flow hedge would need to be recognized in earnings under the hedging guidance.

In addition, the hedging guidance requires that if an entity expects at any time that the continued reporting of a loss in AOCI would lead to it recognizing a net loss on the combination of the hedging instrument and the hedged transaction (and related asset acquired or liability incurred) at some point in the future, a loss must be reclassified immediately into earnings for the amount that is not expected to be recovered. For example, an entity would need to reclassify a loss previously deferred in AOCI related to a hedge of the forecasted purchase of inventory to the extent that the continued deferral of this loss would otherwise be expected to result in the recognition of a loss at the time the inventory is sold.

**Debt, debt covenant violations or repayment accelerations**

Market volatility may lead to liquidity issues, debt covenant violations or redetermination events (periodic reassessments of the value of collateral by the lender) that affect an entity's rights and obligations under its long-term debt agreements. For example, the recent declines in oil prices could reduce the value of underlying reserves used to support reserve-backed lending arrangements. These issues could, in turn, affect debt classification, require waivers from lenders, affect liquidity or result in potential going concern issues. When there are debt covenant violations or other defaults at the balance sheet date, companies should consider the debt classification guidance in ASC 470-10-45 to determine the appropriate classification of long-term debt.

To address liquidity issues, some entities may use more complex debt or equity instruments that could have accounting consequences. Entities should carefully evaluate the nature and terms of these agreements to determine whether they are debt or equity instruments and whether they contain embedded derivatives or other features that require special accounting treatment. The terms of these arrangements also may affect presentation and disclosures.

**Troubled debt restructurings, bankruptcy and liquidation**

A borrower may enter into a troubled debt restructuring (TDR) if its creditor, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise have granted. TDRs may involve a modification to the terms of a debt instrument or an exchange of debt with the same lender before final settlement. The modification could include transfers of receivables or other assets or the issuance or granting of an equity interest in full or partial satisfaction of a debt obligation. A TDR also could involve a reduction in the interest rate, an extension of the maturity date at a stated interest rate that is below market, a reduction of the principal amount of debt or forgiveness of some or all accrued interest.

A key element to determining whether a modification or exchange is a TDR is determining whether the entity is experiencing financial difficulties or is making modifications or exchanges in the ordinary course of business. This could require significant judgment. When an entity determines that a modification or exchange is a TDR, specific accounting rules apply.
Some entities may enter into formal bankruptcy proceedings under Chapter 11, which has special accounting and reporting requirements. The guidance on TDRs does not apply to restructurings that result in a general restatement of an entity's liabilities (e.g., a reorganization under bankruptcy law).

If an entity decides to liquidate (under Chapter 7 bankruptcy or otherwise) and liquidation of the entity is imminent, as defined in US GAAP, the liquidation basis of accounting is required.

**Income taxes**

A sustained period of low oil, natural gas and refined product prices could introduce uncertainty about an entity’s ability to realize deferred tax assets. Related liquidity issues also could force entities to rethink whether foreign earnings continue to meet the indefinite reinvestment criteria or whether a deferred tax liability should be recorded.

Companies with interim reporting requirements need to make their best estimate of the effective tax rate they expect to be applicable for the full fiscal year. If a reliable estimate cannot be made, the actual effective tax rate for the year to date may be the best estimate of the annual effective tax rate.

**Mergers and acquisitions**

Some oil and gas entities may take advantage of a low-price environment by acquiring assets or businesses. It is important that entities that make acquisitions properly assess whether they have acquired a business or a group of assets, because the accounting for a business combination differs significantly from that of an asset acquisition. Entities involved in mergers and acquisitions should also make sure they appropriately challenge the inputs and assumptions they use in estimating the fair value of acquired assets and liabilities, especially those based on long-term price and volume forecasts.

**Other SEC reporting matters**

In the past, the SEC staff has provided reporting considerations for entities when oil prices have declined. These include:

- Whether management’s discussion and analysis should include potential trends or uncertainties associated with a low-oil-price environment
- Whether the risk factors an entity discloses adequately address risks of impairments or other unfavorable outcomes from the price decline
- Whether an entity has made a final investment decision for recognized PUDs

The SEC staff frequently asks other questions about oil and gas reserves, particularly about PUD recognition. The appropriateness of recognizing these reserves will likely receive more scrutiny in the current environment.

**Other considerations**

Depending on the facts and circumstances and the entity’s operations, there could be other effects from the recent declines in oil, gas and refined product prices. Entities may modify existing contracts, which could require changes to their accounting. Entities also may modify employment agreements, share-based payments, pension or other postemployment benefit programs or initiate workforce reductions. Each of these may require entities to apply specific accounting guidance.
Going concern

ASC 205-40, *Presentation of Financial Statements – Going Concern*, requires management to evaluate an entity's ability to continue as a going concern within one year after the date the financial statements are issued (or available to be issued, when applicable). This evaluation must be performed by management for each annual and interim reporting period. Affected companies will need to consider the combined effects of the risks described above and other risks that may indicate uncertainty in their going concern evaluation. Accordingly, management may need to update the cash flow projections (e.g., capital expenditures, availability on credit facilities, debt covenant violations) it uses in its going concern evaluation.

Disclosures in the notes to annual and interim financial statements are required if management concludes that substantial doubt exists or that its plans alleviate substantial doubt that was raised. Management is required to make its evaluation and provide the relevant disclosures for both annual and interim reporting periods.

Subsequent events disclosures and related accounting

Entities should consider events that occur between the date of the financial statements and the date they are issued or available to be issued. Determining whether events in this period should result in adjustments to the financial statements and/or should be considered for separate disclosure depends on the nature of the subsequent event and the accounting topic.

Additionally, we generally believe debt in default at the date the financial statements are issued or available to be issued should be viewed similarly to debt that is in default at the balance sheet date.

Interim reporting

Entities with interim reporting requirements may need to consider whether any of the factors described above affect interim financial statements.

Considerations for other industries

Volatile commodity prices also can affect entities that do business with entities in the oil and gas industry. This can include suppliers and other service providers for oil and gas entities (e.g., steel pipe manufacturers), lenders and customers (e.g., petrochemical manufacturers) that have direct or indirect exposure to the industry. Some of the issues these entities may need to consider are similar to those of oil and gas companies described above, for example:

- Estimates of variable consideration in new and ongoing contracts under ASC 606 and collectibility issues related to financing receivables and contract assets, including the allowance for loan losses for lenders, especially those associated with upstream and oilfield service entities or others that rely heavily on oil- and gas-related revenues
- TDRs, since it may be necessary to modify a borrower’s payment terms (including giving a borrower more time to pay its debt) if the low-price environment affects a borrower’s liquidity
- Inventory valuation and impairment, including potential adjustments for firm purchase commitments, especially for inventories of refined products or for products that have a significant crude component (e.g., petrochemical products) or inventories of steel pipe and other equipment sold to oil and gas entities
- Asset impairments, especially for long-lived assets and intangibles that are used to provide services or manufacture goods to support the oil and gas industry, or those in regions that benefited economically from the recent boom in oil and natural gas production
- Derivative valuation and hedge effectiveness implications and related liquidity risks related to collateral requirements that are similar to those previously described for oil and gas entities
Internal control over financial reporting

Entities that report on internal control over financial reporting (ICFR) should consider whether there are any new or heightened financial reporting risks caused by the recent declines in oil and gas prices and whether internal controls continue to be sufficiently precise to mitigate those risks. For example, the controls over a goodwill impairment test may need to be more precise when small changes in assumptions may affect whether the entity recognizes an impairment loss. Decreases in earnings of the affected entities may affect whether existing controls are sufficiently precise to mitigate risks. These decreases also could affect which processes are significant to financial reporting, which may require the entity to identify additional internal controls.

Additionally, entities with control owners working remotely because of the coronavirus outbreak should consider whether their internal control over financial reporting continues to be designed appropriately. For example, entities should consider whether reviews that take place remotely are appropriately documented.

Next steps

• Management should consider the risks associated with recent declines in oil and gas prices and make sure the entity has an appropriate plan to respond to those risks.

• Management should discuss its approach to responding to the risks posed by recent declines in oil and gas prices with the entity's auditor and its audit committee (or those charged with governance).

• Management of entities that report on ICFR should make sure the control structure is designed and operating at a level that would mitigate the risks to the financial statements.