Federal Accounting Standards Advisory Board

June 17, 2009

Memorandum

To: Members of the Board

From: Julia E. Ranagan, Assistant Director

Through: Wendy M. Payne, Executive Director

Subj: Natural Resources – **Tab E Additional Material**[1]

OVERALL MEETING OBJECTIVE

The purpose of this 90-minute session is to reach consensus on the changes incorporated into the **pre-ballot draft** revised exposure draft (ED) on *Accounting for Federal Oil and Gas Resources* so that staff can work towards a ballot draft.

BRIEFING MATERIAL

This memorandum discusses proposed revisions to the pre-ballot draft sent to members on June 5, 2009 that staff believes to be editorial in nature. Attached are the additional changes that have been proposed.

PROPOSED EDITS TO PRE-BALLOT DRAFT

- Paragraph 10 – Changed the word "uses" to "resources" at Mr. Steinberg's recommendation.
- Paragraph 27 – Removed "Upon collection" from the beginning of the paragraph because it was considered misleading by Mr. Steinberg.
- Paragraph A44 – Added clarifying language based on inquiry from Ms. Kearney of OMB.
- Page 55 – Moved footnote discussion to body of entry and corrected a percentage.
- Page 69 – Updated to reflect new Treasury member.

In addition, in paragraph 6, staff added a comment to note that Mr. Steinberg questions the feasibility of the effective date (October 1, 2010) given the earliest date that the standard is to be issued (May 2010). **Do you wish to revise the proposed effective date at this time?**

[1] The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

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Estimation Methodology

5. The Board believes that the detailed estimation methodology for valuing oil and gas natural resources should be developed by federal entities rather than centrally by the Board. In an environment heavily affected by changes in prices, technological advancements, economic and operating conditions, and known geological, engineering, and economic data, estimation methodologies may need to be regularly updated to reflect changing economic and technological conditions.

Effective Date

6. The proposed standards are effective as RSI for periods beginning after September 30, 2010, and as basic information for periods beginning after September 30, 2013, except where specifically designated as RSI. Earlier implementation is encouraged.

Comment: From H. Steinberg: "Considering that the standard will not be issued until 5 months before the beginning of FY 2011, is enough time being provided to agencies for establishing the procedures and systems to gather and report the information?"

Proposed Standards

Scope

7. This Statement applies to federal entities that report information about federal oil and gas resources in general purpose financial reports, including the consolidated financial report of the U.S. Government (CFR), in conformance with proposed Statement of Federal Financial Accounting Standards 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board*.[4]

8. This Statement articulates a general principle that should guide preparers of general purpose federal financial reports in accounting for federal oil and gas resources.

9. This Statement also amends SFFAS 7, *Accounting for Revenue and Other Financing Sources*, to account for and report bonus bid, rent, and royalty collections – currently treated as nonexchange revenue due to the absence of cost information – in accordance with exchange revenue standards.

10. Federal lands contain a variety of natural resources that are not specifically addressed by this Statement, including oil and gas resources that are not under lease, coal, gold, and silver, as well as timber and grazing rights, among other resources. This Statement does not preclude entities from reporting any information about other types of federally-owned natural resources.

Comment: From H. Steinberg

Deleted: uses

Definitions

11. Definitions in paragraphs 12 and 13 are presented first in the proposed accounting standards because of their uniqueness in calculating the asset value of estimated petroleum royalties. Other terms shown in **boldface type** the first time they appear in this document are presented in the Glossary (see page 60). Reviewers of this document may want to examine all definitions before reviewing the proposed accounting standards and Basis for Conclusions.

[4] SFFAS 34 was approved by the Board and sent to the principals for a 90-day review period; the Board expects to issue SFFAS 34 as final in July 2009.

24. The preferred measurement method for valuing the federal government's estimated petroleum royalties is the present value of future federal royalty receipts on proved reserves using a risk-free discount rate described in paragraphs 19 through 21; however, methods for measuring fair value that are consistent with FAS 157, *Fair Value Measurements*, may be acceptable if it is not reasonably possible to estimate present value of future federal royalty receipts on proved reserves using a risk-free discount rate.

25. Once established, the estimation methodology should be consistently followed and disclosed in the financial reports. If environmental or other changes would provide for the development of an improved methodology, the nature and reason for the change in methodology, as well as the effect of the change, should be disclosed. The net effect of a change in methodology after the initial year should be accounted for as a change in accounting estimate effected by a change in accounting principle.[6]

26. A change in accounting estimate should be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in accounting estimate should not be accounted for by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

Liability Recognition and Measurement

27. The majority of the federal government's estimated petroleum royalties from the production of federal oil and gas proved reserves are distributed to state governments, other federal agencies, and the general fund of the U.S. Treasury in accordance with legislated allocation formulas. The legislated allocation formulas constitute a present obligation[7] of the component entity that is responsible for collecting royalties to provide assets to another entity, and the underlying legislation identifies the conditions under which these distributions will be made.

Comment: From H. Steinberg: phrase "Upon collection" as leading phrase was misleading.

Deleted: Upon collection, t

[6] A change in accounting estimate effected by a change in accounting principle is a change in accounting estimate that is inseparable from the effect of a related change in accounting principle. An example of a change in estimate effected by a change in principle is a change in the method of depreciation, amortization, or depletion for long-lived, nonfinancial assets.

[7] The term obligation is used in this Statement with its general meaning of a duty or responsibility to act in a certain way. It does not mean that an obligation of budgetary resources is required for a liability to exist in accounting or financial reporting or that a liability in accounting or financial reporting is required to exist for budgetary resources to be obligated.

paragraphs A75 through A82) and talking with DOI representatives about the alternative methodology that it developed, the Board determined that the estimates that are developed should approximate the present value of future federal royalty receipts on proved reserves known to exist as of the reporting date. The estimates should be based on the best information available at fiscal year-end, or as close to the fiscal year-end as possible. In addition, discount rates as of the reporting date for present value measurements of oil and gas assets and liabilities should be based on interest rates on marketable Treasury securities with maturities consistent with the cash flows being discounted.

A43. While present value is typically considered to be a method for measuring fair value, the present value measurement approach proposed in this ED is based on an entity-specific discount rate, specifically the interest rates on marketable Treasury securities. FAS 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Under FAS 157, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset. As a basis for considering market participant assumptions in fair value measurements, FAS 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The FAS 157 fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets (Level 1) and the lowest priority to unobservable inputs (Level 3). Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset, either directly or indirectly. Therefore, the present value measurement approach proposed in this ED is not a fair value measure consistent with FAS 157.

A44. There is some concern that DOI may not be able to implement and/or obtain a favorable audit opinion on the present value methodology that it proposed as a result of its field testing. To permit additional flexibility in the measurement methods for valuing federal estimated petroleum royalties, the Board has also determined that methods for measuring fair value that are consistent with FAS 157 will be acceptable. Fair value incorporates the effects of uncertainty that are inherent in the cash flows expected in the future from oil and gas activities, including the effects of the additional return demanded by market participants to assume the risk of that uncertainty. Therefore, the proposed standard provides for a measurement method that is based on either (1) the present value of future federal royalty receipts on proved reserves known to exist as of the reporting date using a risk-free discount rate or (2) a market-based fair value measurement consistent with FAS 157.

Deleted: reporting

Comment: Staff added clarifying language based on inquiry from R. Kearney at OMB.

equals the net gain to be recorded:

$171,466,265 – (150,677,667 – 4,416,253 – 5,375) = $25,210,226

Dr Estimated Petroleum Royalties	25,210,226	
Cr Gain on Revaluation of Estimated Petroleum Royalties		25,210,226

To record revaluation of estimated petroleum royalties.

Gains and losses from changes in long-term assumptions (i.e., discount rate and inflation rate) used to measure assets and liabilities for oil and gas should be displayed as a separate line item or line items on the statement of net costs. For this illustration, changes in the discount rate assumption accounted for $200,500 of the gain on revaluation while changes in other assumptions accounted for a $500 loss, resulting in a net gain of $200,000 due to changes in assumptions. See the pro forma illustration on page 57.

To record the increase in the liability for the revenue distributions to non-federal entities, the amount that the total estimated petroleum royalties was increased due to revaluation is multiplied by the average share of the revenue distributed to state governments and other non-federal entities. For this illustration, 15 percent was used as an average annual share of the revenue distributed to state governments and other non-federal entities based on the average distribution for 2005.[42] This calculation is presented below:

$25,210,226 X .15 = $3,781,534

Dr Revenue Designated for Others – Non-Federal	3,781,534	
Cr Liability for Revenue Distributions to Others – Non-Federal		3,781,534

To record the year-end increase in the liabilities for the revenue distributions to non-federal entities (the 84% expected to be distributed to federal entities increases the net position of the entity responsible for making royalty collections until such time that the collections are distributed and recognized as a transfer out).

The pro forma financial statements that follow are illustrative of the departmental entries presented in this appendix. The "other federal component entity" financial statements and the consolidated financial statements of the United States Government are not illustrated.

Comment: Text of deleted footnote read "This gain will be illustrated on the statement of net cost as partially due to changes in assumptions."

Deleted: [41]

Comment: From field test team: add a sentence or two in entry 11 to explain the gain/loss on assumption. Staff deleted brief footnote explanation (see above) in favor of this more detailed explanation to help track the amount into the statements more easily.

Comment: Corrected to be consistent with other entries: (1) 15% nonfederal, (2) 84% other federal entities, and (3) 1% retained by the entity responsible for collecting royalties

Deleted: *85*

[42] See footnote 29.

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