Indian Institute of Management Kozhikode

Case Study

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Accounting for Oil Exploring Activities at Oil and Natural Gas Corporation (ONGC) Limited

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Diversity in Accounting:

The balance sheet, income statement and cash flows statement are based on several accounting decisions made by the managers of the reporting company. Some of the frequent mutually exclusive accounting decisions are related to valuation of inventory, depreciation, measurement of plant, property and equipment (PPE). Managers can do valuation of inventory and cost of goods sold based on first-in-first-out method (FIFO) or weighted average method (WA) or last-in-first-out (LIFO) or specific identification method. Similarly, managers can depreciate the non-current assets based on either straight-line method or diminishing balance method or depletion method. Managers also have a choice of reporting PPE at either acquisition cost or market value. Across the globe, the managers while preparing financial statements can choose the suitable accounting methods and have diversity in accounting for better presentation of true financial performance and condition of the company for a particular period. Thus, understanding of accounting decisions of a company and diversity in accounting among two or more than two companies is vital in analysis of financial statements. This case addresses in detail the diversity in accounting policies for oil and gas exploring activity of Oil and Natural Gas Corporation (ONGC) Limited.

Oil Exploring Activities:

The prime activities of any oil exploring enterprise are acquisition, exploration, development and production.

Acquisition activity of an oil exploring companies consists of identification of land, acquiring rights to use the land for exploration of oil, development of oil well and production of oil, acquisition of Petroleum Exploration Licence (PEL) and Ming Lease licence from government to explore the oil. Legal fee, salaries, travel cost, material cost and compensation to farmers are some of the costs incurred as part of acquisition activity.

Exploration activity of an oil exploring companies comprises of surveys related to geological, aerial, geophysical, palaeontological, geochemical, topographical, palynological and seismic, analysis and interpretation of these survey reports, investigation and tests related to drill, preparation of site for drilling, drilling for exploration, appraisal of wells and many other related to exploration.

When evaluation of the exploratory projects indicatesthe existence of oil reserves in sufficient volume, development activities commence for production of oil in future. The development activities include the designing and construction oil wells, pipelines for transportation and storage of oiland drilling of production wells.

The production of crude oil well begins after development of oil wells and ready for production. In short, the production activityconsists of pre-wellhead and post-wellhead activities.

Accounting for Oil Exploring Activities:

According to Guidance Note on Accounting for Oil and Gas Producing Activities (Revised 2013) as presented in **Exhibit-1**, there are two alternative methods of accounting for cost incurred for acquisition, exploration and development activities:

1. Successful Efforts Method

2. Full Cost Method

About Oil and Natural Gas Corporation of India Limited (ONGC):

Oil and Natural Gas Corporation (ONGC) Limited was established in 1956 by Government of India as a public sector unit to develop the oil and natural gas resources in the various regions of the country. Prior to establishment of this company by government of India, a few private players were exploring and producing the petroleum and gas in India. Later, ONGC expanded their investments to Vietnam, Sakhalin, Columbia, Venezuela, Sudan etc. Currently, ONGC is the leader in oil exploration and production in India by producing 72 percent of total crude oil produced in India and 48 percent of total natural gas produced in India[1]. Government of India recognized ONGC as one of the Navratnas in 1997 and conferred Maharatna status in 2010. This company is one of the largest profit-making public-sector units in India according to a government survey. It is also ranked as 7th among the top 250 global energy companies as per S&P Global Platts.

Accounting for Oil Exploring Activities at ONGC:

According to Significant Accounting Policies (**Exhibit - 2**) of ONGC disclosed in its annual report for the year 2014-15, the company used Successful Efforts Method of accounting for oil exploring activities. The balance sheet, income statement and cash flows statement are based on Successful Efforts Method are presented in **Exhibit – 3**. The additional disclosures related to Exploratory wells in progress of ONGC are presented in

Exhibit – 4.

Dilemma of ONGC:

Mr. Srinivas.K, a fund manager working with an institutional investor in India, feels that the ONGC is not able to present its true financial condition and performance of the company due to Successful Efforts Method of accounting for oil exploring activities. He says that this kind of method is conservative and thereby, resulting in understatement of assets and profits in the current year. The major competitor in the domestic market and many competitors in the international market are preparing financial statements based on Full Cost Method of accounting which is an aggressive method of accounting in the view of Srinivas. He strongly feels that this company should make their financial accounting policies and financial statements comparable to other companies in the market.

He wrotean email to accounting and other senior executives of ONGC Limited. A few senior executives were not even aware of existence of choice in accounting for exploring cost. Every year, ONGC's oil exploratory cost is more than INR 10,000 crores s (**Exhibit-4**) in past five financial year. The executives feel that if the company had company followed Full Cost Method, financial statements would have been different from what they are now. After reading the email from Srinivas, they decided to review the alternative accounting methods for oil exploring activity of the company in their internal meeting and also would like to take the recommendation of a management consultant to decide whether to change the method of accounting from Successful Efforts Method to Full Cost Method or not.

Questions:

1. Under Successful Efforts Method (SEM) and Full Cost Method (FCM), explain the accounting treatment for INR 200 spent on exploring activities of project-A with oil reserves and INR 100 spent on exploring activities of project-B with dry oil reserves during financial year 2014-15.
2. What will be the impact of change in accounting from Successful Efforts Method to Full Cost Method on Balance Sheet, Income Statement and Cash Flows Statement during the year 2014-15?
3. Is it legal to change the accounting method from Successful Efforts Method to Full Cost Method?
4. Is it ethical to change the accounting method from Successful Efforts Method to Full Cost Method?

5. Do you recommend for change in accounting policy for exploring activity at ONGC? Explain.
6. If you recommend for change in accounting method at ONGC from Successful Efforts Method to Full Cost Method, how do you justify the change in the annual report of 2014-15?

Exhibit 1: Guidance Note on Accounting for Oil and Gas Producing Activities (Revised 2013)

Successful Efforts Method:
Description

15. Under the successful efforts method, generally only those costs that lead directly to the discovery, acquisition and development of specific oil and gas reserves are capitalised and become part of the capitalised costs of the cost centre. Costs that are known at the time of incurrence to fail to meet this criterion are generally charged to expense in the period they are incurred. When the outcome of such costs is unknown at the time they are incurred, they are recorded as capital work-in-progress/intangible asset under development and written off when the costs are determined to be non-productive.

Full Cost Method:
Description

16. Under the full cost method, all costs incurred in, acquiring mineralinterests, exploration, and development, are accumulated in cost centres thatmay not be related to geologicalfactors. The cost centre, under this method,is not normally smaller than a country except where warranted by majordifference in economic, fiscal or other factors in the country. The capitalisedcosts of each cost centre are depreciated as the reserves in each cost centreare produced.

Source: Guidance Note on Accounting for Oil and Gas Producing Activities (Revised 2013) issued by Institute of Chartered Accountants of India

Exhibit 2: Significant Accounting Policies

2. Significant Accounting Policies

Basis of Preparation

The financial statements are prepared under the historical cost convention on accrual basis in accordance with Generally Agreed Accounting Principles (GAAP), applying Successful Efforts Method as per the Guidance Note on Accounting for Oil and Gas Producing Activities (Revised) issued by Institute of Chartered Accountants of India and Accounting Standards as prescribed under the Companies (Accounts) Rules, 2014 and provisions of the Companies Act, 2013.

Source: Annual Report of ONGC Limited for 2014-15

Exhibit 3: Financial Statements of ONGC Limited

Balance Sheet of ONGC Limited as on 31st March, 2019 (INR in million)

Particulars	**Note No**	**As at 31st march 2015**	**as 31st march 2014**
I. EQUITY AND LIBILITIES			
1.Shareholder's fund			
(a) Share capital	3	42,777.60	42,777.60
(b) Reserve and surplus	4	14,03,232.15	13,24,472.45
2. Non-current liabilities			
(a) Deferred tax liabilities (Net)	5	1,77,331.54	1,65,786.78
(b) Other long-term Liabiliti*es*	6	11,288.85	11,779.09
(c) long-term capital provision	7	2,54,433.79	2,57,270.72
3. CURRENT LIABILITIES			
(a) Short-term borrowings	8	13,930.00	0.00
(b) Trade payables	9	54,891.03	63,724.81
(c) other current liabilities	10	1,02,938.07	1,19,257.45
(d) Short-term provisions	11	19,975.78	7,815.39
TOTAL		20,80,798.81	19,92,884.29
II. ASSETS			
1. Non-current assets			
(a) Fixed assets			
(i) Tangible assets	12	3,14,211.24	3,02,291.89
(ii) Producing properties	13	6,67,110.29	6,57,832.64
(iii) Intangible assets	14	696.04	500.61
(iv) Capital work-in progress	15	1,26,906.58	1,16,450.34
(v) Exploratory/Development Wells in progress	16	1,58,885.29	1,39,127.59
(b) Non-current investments	17	1,81,242.83	1,72,043.06
(c)Long-term loans and advances	18	1,94,708.20	1,81,783.61
(d) Deposits under site restoration fund scheme	19	1,25,443.80	1,13,101.59
(e)Other non-current assets	20	9,962.00	11,319.96
2.CURRENT ASSETS			
(a) current investments		0.00	0.00
(b) Inventories	21	59,635.27	58,825.41
(c)Trade receivables	22	1,35,782.74	81,656.70
(d) Cash and cash-equivalents	23	27,600.68	1,07,988.77
(e) short-term loans and advances	24	69,476.77	43,669.60
(f) Other current Assets	25	9,137.08	6,292.52
TOTAL		20,80,798.81	19,92,884.29

Source: Annual Report of ONGC for 2014-15

Statement of profit and loss for the year ended 31st March, 2015 (INR in million)

Particulars	**Note No**	**2014-15**	**2013-14**
1. INCOME			
Revenue from operation (gross)	26	8,30,934.67	8,42,027.80
Less: Excise duty		2,225.06	3,125.09
Revenue from operations (Net)		8,28,709.61	8,38,902.71
Other Income	28	53,665.67	67131.99
TOTAL REVENUE		8,82,375.28	9,06,034.70
2. **EXPENSES**			
(Increase)/ Decrease in inventories	29	(1,674.29)	1,042.80
Purchase of stock-in-trade	44.2.2	44.11	31.8
Production, Transportation, selling and distribution expenditure	31	3,92,662.80	3,93,334.90
Exploration cost written off			
Survey cost		19,146.47	15,911.62
Exploratory well cost		86,078.16	62445.15
Depreciation, depletion, amortisation, Impairment	32	1,14,583.12	1,09,258.90
Financing cost	33	27.87	3.57
Provisions and write-offs	34	2,115.60	2,188.50
Adjustment relates to prior period	35	3,839.09	(2,501.86)
TOTAL EXPENSES		6,16,822.93	5,81,715.38
Profit before exceptional, extraordinary items and tax		2,65,552.35	3,24,319.32
Exceptional items		0.00	0.00
Profit before extraordinary items		2,65,552.35	3,24,319.32
Extraordinary items		0.00	0.00
profit before tax		2,65,552.35	3,24,319.32
Tax expenses:			
Current tax		82,000.00	65,500.00
MAT credit entitlement		0.00	(2,800.00)
Earlier years		(5,848.30)	2,145.87
Deferred tax		12,071.11	38,525.38
profit after tax		1,77,329.54	2,20,948.07
Earnings per equity share- basic and diluted	36	20.73	25.83
(face value₹ 5/- share)			

Source: Annual Report of ONGC for 2014-15

Cash flow statement for the year ended 31st March, 2015(INR in million)

	Year ended 31st march 2015	Year ended 31st march 2014
A. CASH FLOW FROM OPERATING ACTIVITIES:		
Net profit before tax and extraordinary items	2,65,552.35	3,24,319.32
Adjustments for:		
Prior Period Items	3,839.09	(2,501.86)
Depreciation, Depletion, Amortisation and Impairment	1,14,583.12	1,09,258.90
Exploratory well written off	86,078.16	62,445.15
Interest on borrowings	27.87	3.57
Unrealized foreign exchange Loss/(gain)	222.91	341.11
Provision for leave Encashment	1,556.81	(17,273.47)
Provision for other employee benefits	3,279.49	2,764.16
Other provisions and write-offs	2,115.60	2,188.50
Excess provision written back	(6,456.33)	(16,328.86)
Provision for abandonment	283.48	243.56
Interest income	(30,564.45)	(33,006.23)
Excess Liability written back	(856.54)	(2,836.39)
Amortization of Government Grant	(14.17)	(2.87)
Dividend Income	(4,889.51)	(3,744.37)
Operating profit before working capital changes	4,34,757.88	4,25,870.22
Adjustments for:		
Receivables	(54,503.49)	2,779.65
Loans and advances	(28,881.97)	(2,677.53)
Other currents assets	(225.33)	4300.38
Inventories	(542.54)	(2,704.45)
Trade payables and other liabilities	(24,277.96)	29,225.79
Cash generated from operation	3,26,326.59	4,56,794.06
Direct tax paid (Net of Tax refund)	(76,080.81)	(78,080.58)
Cash flow before Prior Period	2,50,245.78	3,78,713.48
Prior Period items (Cash items)	(524.6)	166.71
Net cash flow from operating activities 'A'	2,49,721.18	3,78,880.19
B. CASH FLOW FROM INVESTING ACTIVITIES		
Purchase of fixed assets	(82389.32)	(1,01,082.42)
Sale of fixed assets	62.27	7.28
Exploratory and development drilling	(1,77,557.51)	(1,99,047.62)
Advance/Investment in Joint Controlled Entities	(2,516.54)	(9,910.69)
Loan to Associates	350.45	337.88
Loan and advances to subsidiary	(5,961.93)	6,941.01
Investments/Loans to Public Sector Undertakings	0.00	(26,707.47)
Deposits in site restoration fund	(12,342.21)	(11,770.38)
Dividend received from associates	37.80	11.46

Dividend received from other investments	4,851.71	3,732.91
Interest received	26,332.31	31,984.50
Net cash flow from investing activities ‘B’	(249132.97)	(305503.54)
C. CASH FLOW FROM FINANCING ACTIVITIES		
Short-term borrowings	13,930.00	0.00
Dividend paid	(79,133.08)	(83,399.48)
Tax on dividend	(15,748.94)	(14,170.69)
Interest Paid	(24.28)	(3.57)
Net cash flow from Financing Activities 'C'	(80,976.30)	(97,573.74)
Net Increase/(decrease) in cash and cash Equivalents (A+B+C)	**(80,388.09)**	**(24,197.09)**
Cash and Cash Equivalents as at 1st April 2014 (opening balance)	1,07,988.77	1,32,185.86
Cash andCash Equivalents as at 31st March 2015 (Closing balance)	27,600.68	1,07,988.77
	(80,388.09)	(24,197.09)

Source: Annual Report of ONGC for 2014-15

Exhibit - 4: Exploratory wells in progress of ONGC (INR in million)

Particulars	As at 31st March, 2015	As at 31st March, 2014
(A) EXPLORATORY WELLS IN PROGRESS		
Gross Cost		
Opening Balance	1,33,955.37	86,489.94
Expenditure during the year	1,11,701.28	1,16,872.08
Less: Sale proceeds of Oil and Gas	547.85	470.54
	1,11,153.43	1,16,401.54
Depreciation during the year ((Note No.32)	3,284.45	2,506.44
	2,48,393.25	2,05,397.92
Less:		
Transfer to producing properties	10,189.11	8,950.30
Wells written off during the year	88,137.36	62,508.91
Other adjustments	2,638.80	-16.66
	1,47,427.98	1,33,955.37
Less: Provisions (Note no-16.1)/Impairment (Note no-42.6)		
Opening Balance	24,518.71	17,169.79
Provided during theyear	1,177.50	7,348.92
Write back during the year	-1,203.23	0
Exploratory wells-in-Progress (A)	1,22,935.00	1,09,436.66

References:

1. https://www.ongcindia.com/wps/wcm/connect/en/about-ongc/history/ (accessed on 24 Dec, 2020)

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