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The Big Drop: How the Low Price of Oil Is Affecting the Oil and Gas Industry

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The price of oil has ebbed and flowed, often erratically, over the years in response to geopolitical events and changes in supply and demand.

In 1973, for example, when OPEC declared an oil embargo against the United States and Western Europe for their support of Israel, the price of oil shot up from $4 a barrel that October to $10 a barrel the following March. It was considered by many the first "oil shock," but it hardly would be the last.

In September 1980, at the start of the long war between Iran and Iraq, Iran cut off production and canceled contracts with the United States. As Iraq's production declined in tandem, by April 1980, the price of oil had skyrocketed to $40 a barrel. Other countries stepped in to fill the gap in production. The result was overproduction, and the price dropped to $13 a barrel by March 1986, resulting in mass layoffs throughout the industry.

After the Iraqi invasion of Kuwait in 1990, the price of oil doubled from $18 a barrel in July 1990 to $36 a barrel three months later. Then global demand plummeted following the Asian financial crisis of 1997, sending oil prices spiraling downward from $25 a barrel to $12 a barrel in 1999.

A strengthening global economy during the following years boosted demand for oil at a time when supply was low, resulting in a price of $134 a barrel by 2008. Then the global financial crisis struck that sent the price of oil tumbling to $41 a barrel. By 2012, the recovery had brought the price back to $106 a barrel.

That brings us to today. Oil prices have fallen more than 50 percent over the last year and a half as a result of increased global production and lower demand. It's a decline that many think will continue for the foreseeable future. [Editor's note: Oil prices hit a seven-year low in early December 2015, with U.S. crude falling below $37 a barrel.] Based on the volatile history of oil pricing, it's hard to say when prices will rebound.

FTI Consulting, under the auspices of The Experts Forum, assembled a panel of professionals in November 2015 at the **Securities and Exchange Commission (SEC) Historical Society** in Washington, D.C., for a live broadcast on "The Impact of Falling Oil Prices on Financial Reporting." Topics covered include how much longer low oil prices likely would persist, the impact of this protracted depression in price on the operations and financial reporting of companies in the oil and gas industry, and the role and focus of the SEC and auditors during this difficult time. (**The broadcast is permanently available in audio/mp3 and edited transcript formats in the virtual museum and archive of the history of financial regulation**.) The following discussion is an edited excerpt from the broadcast.

The panel was moderated by:

CRAIG LEWIS
Ph.D., Madison S. Wigginton Professor of Finance at Vanderbilt University's Owen Graduate School of Management, and included:

GARY GOOLSBY
Senior Managing Director in the Houston office of FTI Consulting, who has provided professional services to the oil and gas industry (among other sectors) for 40 years.

CHRIS CHAMPION
Vice President – Chief Accounting Officer and Controller at Anadarko Petroleum Corporation, one of the world's largest publicly traded oil and gas exploration and production companies.

DAVID WOODCOCK
Partner in the Securities Litigation and SEC Enforcement practice of Jones Day in Dallas. Woodcock previously was Regional Director at the SEC's Fort Worth Regional Office and Chair of the SEC's Financial Reporting and Audit Task Force.

DR. CRAIG LEWIS: The one thing we know for sure about oil prices is that they're volatile. How long are oil prices likely to continue falling?

DAVID WOODCOCK: As energy scholar Daniel Yergin said, "Cycles of shortage and surplus characterize the entire history of oil." That will always be true.

CHRIS CHAMPION: When all this started in the fall of 2014, everyone assumed we would be coming up the commodity curve by now. But there was a second dip during the summer and fall of 2015. Companies are able to drill and do more with less capital. There are in excess of 400 million barrels of inventory in the United States and a lot of uncompleted wells that will have to work their way through the system. In addition, geopolitical issues aren't having much impact. Who would have thought that the recent Russian bombing in the Middle East would have had no measureable effect on oil prices? The phrase that's catching on right now in the industry is "lower for longer." I am hopeful that, sometime in mid to late 2017, we'll begin to see some kind of meaningful recovery in oil prices.

We focus so much on the price of oil that natural gas often gets overlooked in the discussion. However, natural gas also has fallen sharply — 25 percent in the United States since the end of 2014, which is even more of a decrease than

oil. And with a strong El Niño bringing a warmer winter to much of the country, the price of natural gas may be lower for an extended period.

GARY GOOLSBY: There are so many external forces that could impact oil [and natural gas] prices. It's difficult to know how and when they will have an effect. But if this price decline continues for the foreseeable future, that will have a dramatic impact on strategies, accounting and disclosure issues for oil and gas companies.

DAVID WOODCOCK: There already has been a noticeable shift in behavior within the exploration and production sector. Issues that could have been worked out in better times generally escalate. And the climate is ripe for more litigation. If you're locked into a contract that was profitable at only $100, $90 or $80 a barrel, you may have to consider insolvency, which is something no one wants. Globally, some 200,000 people already have lost their job. The longer this situation lasts, the more problematic it will become for entities of every size. Even the larger companies capable of operating in a lower price environment will feel it.

What Are the Middle Eastern Oil Producers Thinking?

DR. CRAIG LEWIS: Even with all these factors in place, Saudi Arabia, for one, decided not to slow production. What might motivate countries in the Middle East to want to keep oil prices at their current levels?

GARY GOOLSBY: Many believe Saudi Arabia is maintaining production levels to challenge other constituents such as U.S. shale oil production players. If the prices stay low enough, shale oil production becomes uneconomical, and, theoretically, supply goes down and prices go up.

It's a complex issue, however. Many Middle Eastern countries are dependent on cash flow from oil. Even Saudi Arabia is borrowing money to finish projects rather than taking money out of available cash. Saudi's archrival, Iran, has indicated that it wants to unleash production when its nuclear-related sanctions are lifted. Libya's oil industry is falling apart after four years of war. No one knows how all this will shake out over time.

DAVID WOODCOCK: That's right. Saudi Arabia has not taken its foot off the pedal of production. There's been remarkable growth in U.S. production capabilities. And all this is happening on the heels of what is believed to be an economic slowdown in China and elsewhere. There's a ton of supply and possibly slowing demand, and the Saudis are making a bet on who can hold out the longest.

Accounting in an Environment of Declining Profitability

DR. CRAIG LEWIS: What kinds of accounting issues are falling oil prices creating for oil and gas companies?

CHRIS CHAMPION: When we talk about oil and gas, sometimes we focus only on the upstream companies. But this is a very active time for organizations across the value chain. The drillers and oil field services companies are actually the tip of the spear — they're the first ones to feel the impact of a pricing shift.

There certainly are accounting issues that come along with a drop in price, layoffs and shutdowns, but much of that has to do with asset valuation. Many oil field services companies have been in growth mode for the last decade; there's a lot of goodwill and high asset values on the books. Now that these companies are feeling the pain, they're shedding those assets (which, in many cases, consist of perfectly fine operating rigs that function using older technology so no one wants them). Thus, these assets become valuation and disclosure issues. The exploration and production sector in the United States has recorded billions of dollars in goodwill impairments because those asset values are directly tied to oil and gas prices. It's not representative to look across the industry globally because there are competing financial standards, and impairment measurements vary by method.

In addition, public exploration and production companies are required to provide oil and gas reserve disclosures. In order to keep a proved undeveloped reserve ("PUD") on the books, management intent must be present, and the companies must have the capital available to develop those proved undeveloped reserves. As that becomes less likely, companies will have to remove those assets from their financial statements.

DR. CRAIG LEWIS: The "successful efforts" and "full cost" accounting methods differ in the treatment of specific costs relating to the exploration for and development of new oil and gas reserves. Do you think these methods, used by firms in filing with the SEC, are adequate to inform investors?

GARY GOOLSBY: Companies do a good job of laying out information for investors. Financial reporting includes disclosures related to reserves and other risk factors, management's discussion and analysis of everything from liquidity to forward-looking information, and footnotes articulating how the disclosure rules work. There always will be questions, but that's why we have analyst calls.

DAVID WOODCOCK: The SEC's disclosure rules are designed to be agnostic to the merits of any particular business model or approach. There's been some criticism recently that maybe there's too much information that has to be included. The size of the average 10-K is several hundred pages. But the question is this: Is the company getting the appropriate information to investors in the right way? The disclosure rules try to do that.

DR. CRAIG LEWIS: What is the SEC focusing on when it reviews oil and gas financial statements?

DAVID WOODCOCK: Accounting obviously is very important. But

disclosures, in some ways, are even more critical. The SEC reviews disclosure issues in several ways, including corporate and financial areas.

Most of this work is done by the SEC's Division of Corporation Finance, which is required under Sarbanes-Oxley to conduct selective reviews of corporate filings. It's an enormous task so the division is organized by industry, with a natural resources group dedicated to oil and gas. Staff members are looking for compliance with securities disclosure rules, as well as accounting issues. If a reviewer has questions about something, a comment letter is issued to the company. The company will respond — and thus begins a dialogue between the company and the SEC division. If there are accounting issues involved, those can be escalated to the division's own accountant, the SEC's Office of Chief Accountant.

Comment letters and responses are public so anyone can see what Corporation Finance has focused on in the past. Reserve issues always are of interest. This is not surprising, as they account for the majority of an exploration and production company's value. Reserve issues drive a lot of measures of corporate health that investors care about.

Approximately a quarter of all comments in 2012 and 2013 were related to PUD reserves because they're an important metric used by investors and banks, but they're also subject to much uncertainty. Corporation Finance asks questions about disclosures of material changes to and development of PUD reserves. For example, questions may arise about why a PUD still is on the books five years after investors were told the asset was going to be developed.

There's been increased interest on reserve reports because of new requirements mandating that companies disclose information about the competency of the professionals creating the reports. Other areas of emphasis include present activities, like the number of wells drilled, completed and shut down while awaiting infrastructure. There also have been accounting- related questions about costs and prices such as how a company treats transportation costs.

CHRIS CHAMPION: I spent a lot time when I was in public accounting assisting clients responding to SEC comment letters. The SEC reserve engineers are extremely analytical, and they ask relevant questions based solely on the information a company provides.

> "I would suggest companies pay specific attention to their disclosures. Everyone can do the math — so if something looks out of sorts, then disclosure provides the opportunity to explain the reasoning behind the numbers. Don't pass up that chance because it will save a lot of time in the long run."

DAVID WOODCOCK: The SEC's Division of Enforcement, on the other hand, is the hammer. There's no collaboration. A subpoena is not an invitation to start a dialogue.

Most oil and gas cases filed by the SEC involve private ventures formed to drill wells with money from sophisticated investors. With reduced SEC registration requirements, minimal state filing mandates and no limit on money raised, these particular arrangements are ripe for fraud.

The SEC also files actions against public companies, but those are rarer. Investigations most often involve overstatements concerning oil and gas reserves, more likely undeveloped than developed ones. There was, in 2004, a case related to an overstatement of previously reported reserves for which the company ended up paying $120 million. There was another situation in 2008 in which a company lowered its previously reported reserves by 35 percent, reducing earnings by $1.7 billion.

In every one of these cases, the company was cited for having weak internal controls. That's a standard claim in any kind of disclosure misstatement or accounting fraud, but it's especially true in oil and gas. Sometimes it's a result of poor estimating practices or an insufficient understanding or improper application of the SEC rules. In others, misguided incentives, overconfidence or competition for investors might be the reason for overbooking. But in almost every instance, management had disregarded red flags in the form of reports from third parties or data from the field. If top management thinks something is going to produce X amount but is told in the first year or two that the predictions already are off, it's probably time to adjust those projections.

The same thing likely is happening now with regard to pricing trends. Companies are ignoring the continued price decreases, hoping the situation will improve. So they are keeping assets on the books that shouldn't be included or are valuing them at inflated prices. In almost every one of these cases, management is myopically concentrating on short-term profitability rather than on long-term consequences.

DR. CRAIG LEWIS: In industries where profitability is eroding, there's pressure to make performance appear to be better than it actually is. What sorts of challenges face oil and gas auditors in this kind of environment?

GARY GOOLSBY: Anytime you have an industry facing challenges — particularly with an unknown horizon — an auditor will be skeptical and will dig deeper.

The auditor will be focused especially on risk: the risk of overstatement of assets; the risk of not booking accruals

for severance when people have been dismissed; the risk of not booking assets held-for-sale at fair value, etc. The internal controls over financial reporting represent another critical area for the auditor to examine. Sarbanes-Oxley requires management assertion as to the effectiveness of the internal controls and auditor attestation on the assertion.

The auditor also has responsibility for reviewing disclosures outside the audited financial statements to determine if there are any material inconsistencies with what's on the audited financial statements. Forward-looking information about the company's liquidity, debt factors, survival as a going concern — all this is essential to the auditor.

Finally, when dealing with an industry in decline, management representations become critical. The auditor must audit those representations to corroborate what's stated. Communication with the Audit Committee always is meaningful, but, in an unrelenting environment, it's even more crucial to talk with committee members about issues and risks.

DAVID WOODCOCK: What is the auditor's role with regard to third-party experts?

GARY GOOLSBY: The auditor is required to evaluate the qualifications, experience, skills and methodology of third-party experts — from those who provide oil and gas reserve estimates to those who formulate actuarial calculations for pensions. To assist in this important task, there is literature on how to evaluate the credibility of those professionals whose work is used in the presentations included in the financial statements.

CHRIS CHAMPION: Sometimes we say the reserve information is the "most audited, unaudited footnote." When I was on that side of the fence as an auditor, we spent a lot of time reviewing in depth every aspect pertaining to reserves. And it's certainly still a focus today.

DR. CRAIG LEWIS: Thank you all.

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