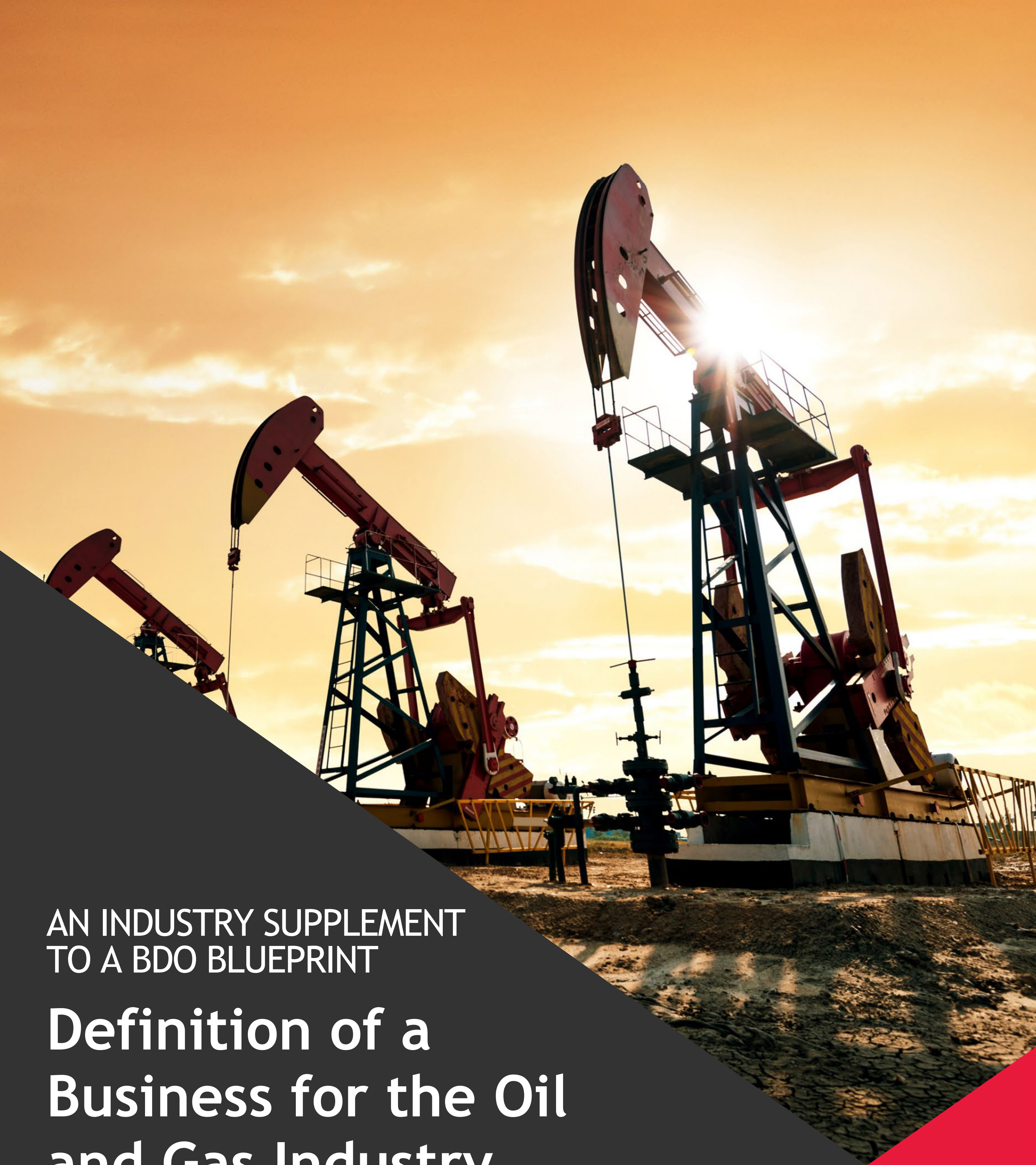

AN INDUSTRY SUPPLEMENT
TO A BDO BLUEPRINT

Definition of a Business for the Oil and Gas Industry

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BDO

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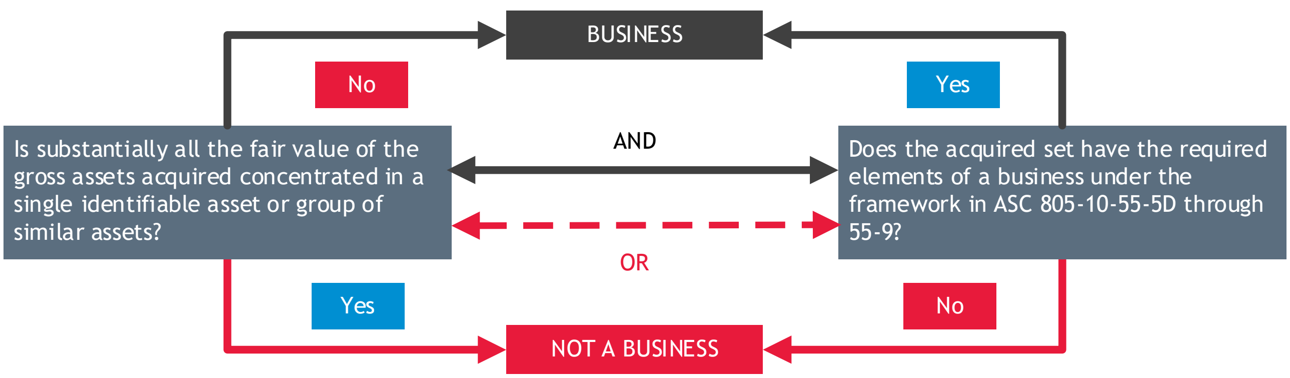
1. Introduction

An oil and gas entity may acquire different types of assets in a single acquisition transaction. For example, the acquired group of assets (acquired set) may include mineral and royalty interests, leasehold rights, proved developed producing wells (PDPs), proved undeveloped wells (PUDs), unproved acreage, or midstream infrastructure. The acquired set may also include processing plants, pipelines, and joint operating agreements (JOAs).

Determining whether an acquired group of assets and liabilities meets the definition of a business is an important decision because there are significant differences in accounting for business combinations and asset acquisitions. Accounting Standards Codification (ASC) 805, *Business Combinations,* requires that an acquirer assess (1) whether substantially all the value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets (the screen test); and (2) whether the acquired set includes the required elements of a business under the framework in ASC 805.

Definition of a Business



If substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not a business (see Section 2). Conversely, if the screen test is not met, the acquirer must determine whether the acquired set has the required elements of a business (see Section 3).

At a minimum, a business consists of inputs and processes that can contribute to the creation of outputs when combined. Although businesses usually have outputs, outputs are not required for an acquired set to qualify as a business. However, the criteria for concluding that an acquired set is a business are more stringent when outputs are not present.

- If the acquired set has outputs, it must have an input and a substantive process (see Section 3.2).
- If the acquired set does not have outputs, it must include employees that form an organized workforce and another input (in other words, an input other than employees) the workforce could develop or convert into outputs (see Section 3.1).

An entity can perform the screen test and evaluate the elements of a business in whichever order it prefers. If one test indicates that the acquired set is not a business, there is no need to perform the other. Conversely, even if the acquired set includes all the elements of a business, the screen test must be performed.

Determining whether the screen test is met for an oil and gas entity can require significant judgment, specifically when determining whether individual assets have similar risk characteristics and therefore can be grouped into a single asset for purposes of the screen test. Also, for an acquired set that fails the screen test, an entity may need to exercise significant judgment when determining whether a substantive process or organized workforce has been acquired.

ABOUT THIS PUBLICATION

This publication provides guidance for evaluating whether a set acquired by an oil and gas entity meets the definition of a business and should be read in connection with BDO's Blueprint, **Business Combinations Under ASC 805**. An oil and gas entity's accounting for acquired sets varies based on the facts and circumstances and therefore might differ from the examples and insights in this publication.

2. The Screen Test

FASB REFERENCES

ASC 805-10-55-5A and ASC 805-10-55-5D through 55-9

ASC 805 requires an entity to evaluate whether **substantially all** the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. For this test, gross assets acquired excludes cash and cash equivalents, deferred tax assets (DTAs), and goodwill resulting from the effects of deferred tax liabilities (DTLs). However, the gross assets acquired includes goodwill — any consideration transferred (plus the fair value of any noncontrolling interest and previously held interest, if any) in excess of the fair value of net identifiable assets acquired.

Gross Assets Acquired = Identifiable Assets + Goodwill − Cash − DTAs − Goodwill from DTLs

BDO INSIGHTS: SUBSTANTIALLY ALL MEANS APPROXIMATELY 90%

While U.S. GAAP does not define the term "substantially all," it is generally interpreted to mean approximately 90% (or more). Although this is not meant to be a bright line, we believe it would be difficult to conclude that a single identifiable asset or group of similar identifiable assets that has a value greater than 90% has not met the threshold. Similarly, if the value of a single identifiable asset or group of similar identifiable assets is more than a few percentage points below 90%, it might be difficult to conclude that the threshold has been met. Reaching a conclusion about whether substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets requires professional judgment based on the facts and circumstances.

BDO INSIGHTS: INCLUDE OR EXCLUDE LIABILITIES FROM THE GROSS ASSETS ACQUIRED

Acquisitions of PDPs can include asset retirement obligations and lease liabilities. Because of the inherent inseparability of an acquired asset and the related asset retirement obligation or of a right-of-use asset and the associated lease liability, the question arises whether those types of liabilities are included in the value of the acquired asset and the total gross assets acquired when applying the screen test. However, Basis for Conclusion paragraph 20 of ASU 2017-01, *Clarifying the Definition of a Business,* states that when performing the screen test, gross assets acquired must exclude the value of any liabilities assumed to avoid debt or other liabilities from affecting the analysis. As such, all liabilities, including asset retirement obligations and lease liabilities, must be excluded from the screen test.

IF THE SCREEN TEST IS MET, NO FURTHER EVALUATION IS NEEDED

If substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the acquired set is not a business and does not require further evaluation. In other words, if the screen test is met, the acquirer cannot conclude that the acquired set is a business even if it includes the required elements of a business under the framework in ASC 805-10-55-5D through 55-9.

2.1 SINGLE IDENTIFIABLE ASSET OR GROUP OF SIMILAR ASSETS

FASB REFERENCES

ASC 805-10-55-5B through 55-5C

The starting point for performing the screen test is to identify the assets that are part of the acquired set. The acquired assets are identified and measured using the principles for business combinations (including any measurement exceptions). In other words, the acquirer uses the same unit of account for identifying assets in the screen test as it would for identifying assets recognized in a business combination.

Identifiable assets often acquired by oil and gas entities include PDPs and related equipment, PUDs, unproved acreage, and mineral and royalty interests. Mineral and royalty interests can include overriding royalty interests (ORRIs) and nonparticipating royalty interests (NPRIs), which are both intangible assets. ORRIs are nonoperating interests carved out of the working interest in a lease and entitle the holder to a percentage of production revenue, free of production costs. They typically expire when the underlying lease terminates. Conversely, NPRIs are carved out of the mineral estate itself and entitle the holder to a share of production revenue without the right to lease the mineral estate or participate in operations. Unlike ORRIs, NPRIs do not expire with the lease.

Once the acquirer has identified and measured the acquired assets in accordance with business combination principles, it must determine whether any of the assets must be combined for the screen test.

For the screen test, the following are considered a single asset:

- A tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset (or an intangible asset representing the right to use a tangible asset) without incurring significant cost or causing significant diminution in utility or fair value of either asset (for example, land and building)
- In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related lease assets

Further, ASC 805 requires that similar assets are combined and assessed as a group of similar identifiable assets if they are similar in nature and share similar risks. Conversely, assets cannot be combined if they are not similar in nature or do not share similar risks. Reaching a conclusion about which assets must be combined and assessed as a group of similar identifiable assets requires professional judgment based on the facts and circumstances.

The following are not considered similar assets:

- Tangible and intangible assets
- Identifiable intangible assets in different major intangible asset classes (for example, JOAs, mineral rights, and permits)
- Financial and nonfinancial assets
- Different major classes of financial assets (for example, accounts receivable and marketable securities)
- Different major classes of tangible assets (for example, inventory, production equipment, and automobiles)
- Identifiable assets in the same major asset class that have significantly different risk characteristics

BDO INSIGHTS: WHEN TO COMBINE ASSETS INTO A SINGLE IDENTIFIABLE ASSET

In the exploration and production sector, entities often acquire land leases and related mineral rights. We believe that the mineral rights and related intangible lease rights are a single identifiable asset for screen test purposes.

Acquisitions in the exploration and production sector might also include production equipment. Although ASC 842, *Leases*, superseded the guidance on integral equipment in ASC 360, *Property, Plant, and Equipment*, the superseded ASC 360 guidance might be helpful when determining whether a tangible asset that is attached to another asset cannot be removed and reused without incurring significant cost. Specifically, before being superseded, ASC 360-20-55-59 indicated that if the cost to remove the equipment and use it separately were more than 10% of the fair value of the equipment, the cost was deemed significant and the equipment represented integral equipment.

BDO INSIGHTS: GROUPING ASSETS WITH SIMILAR RISK CHARACTERISTICS

In the oil and gas industry, whether a group of acquired assets represents a group of similar assets generally hinges on the similarity of their risk characteristics. For example, if an exploration and production entity acquires a group of properties that includes both proved and unproved properties, it must assess whether the risk characteristics of the two types of assets are similar. While unproved properties generally have significantly different risk characteristics than proved properties, that presumption may be overcome in limited circumstances if:

- The properties are in the same geographic area.
- Preliminary studies indicate that the unproved properties are expected to show results consistent with the proved properties.
- The acquirer has a proven record of developing properties in the area.

Similarly, an entity must consider whether PUDs and PDPs have similar risk characteristics. Determining whether acquired mineral and royalty interests, ORRIs, or NPRIs on different properties are similar requires judgment. For example, an acquirer may need to consider the type and location of properties the interests are tied to, as well as the contractual terms, operator practices, geology, and production potential.

Once an acquirer has grouped similar assets, it must divide the value of a single identifiable asset or group of similar identifiable assets by the gross assets acquired. It then must conclude whether substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets.

2.2 SCREEN TEST: EXAMPLES

FASB REFERENCES

ASC 805-10-55-5A through 55-5C

Examples 2-1 through 2-6 illustrate the application of the screen test for different scenarios.

EXAMPLE 2-1: ACQUISITION OF AN OPERATING INTEREST IN PDPS

FACTS

- Oil Explorers LLC acquires a 100% operating interest in PDPs (several hundred producing wells), including the mineral interests and basic lease production facilities, in a single geographic area.
- The fair value of the basic lease production facilities would decline substantially if removed from the properties.
- No employees or other assets were acquired.

CONCLUSION

Oil Explorers LLC concludes that substantially all the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets (PDPs), so the set is not a business.

ANALYSIS

Oil Explorers LLC first considers the guidance in ASC 805-10-55-5A through 55-5C and concludes that each PDP and the related basic lease production facilities are a single asset in accordance with ASC 805-10-55-5B. In other words, the lease production facilities are attached to the PDP (and the associated mineral interests) and cannot be removed without a significant decrease in utility to and fair value of the tangible assets. Further, because the properties are all proved and in the same geographic area, Oil Explorers LLC concludes that the PDPs together constitute a group of similar assets.

EXAMPLE 2-2: ACQUISITION OF AN OPERATING INTEREST IN UNPROVED ACREAGE AND PDPS

FACTS

- O&G Co. acquires a 100% operating interest in mostly unproved acreage, including the mineral interests and basic lease production facilities for the proved producing properties, and a small number of older PDPs (containing less than 100 producing wells).
- The fair value of the unproved acreage constitutes approximately 95% of the fair value of the gross assets acquired.
- The basic lease production facilities would decline substantially if removed from the properties.
- No employees or other assets were acquired.

CONCLUSION

O&G Co. concludes that substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset (unproved acreage), so the set is not a business.

ANALYSIS

When considering the screen test in ASC 805-10-55-5A through 55-5C, O&G Co. concludes that the unproved acreage is a single asset in accordance with ASC 805-10-55-5B. In other words, the lease(s) associated with the acreage must be combined with the mineral interests and considered one asset.

EXAMPLE 2-3: ACQUISITION OF A NONOPERATING WORKING INTEREST IN PROVED AND UNPROVED PROPERTIES

FACTS

- Exploration and Production Co. (E&P Co.) acquires a 50% nonoperating working interest in proved properties, which contain several hundred PDPs, dozens of PUDs, the related mineral interests, basic lease production facilities, and two joint operating agreements with two separate operators with different drilling and completion techniques.
- The fair value is split pro rata between the two operators, and the PDPs do not constitute substantially all the fair value of the gross assets acquired in the set.
- The basic lease production facilities would decline substantially if removed from the properties.
- No employees or other assets were acquired.

CONCLUSION

Substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset or a group of similar identifiable assets. E&P Co. must consider whether the assets acquired meet the definition of a business, as discussed in Section 3.

ANALYSIS

E&P Co. considers guidance in ASC 805-10-55-5A through 55-5C and concludes that each PDP and the related basic lease production facilities are a single asset in accordance with ASC 805-10-55-5B. In other words, the lease production facilities are attached to the PDPs (and the associated mineral interests) and cannot be removed without a significant decrease in utility to or fair value of the tangible assets.

However, E&P Co. concludes that the PDPs and PUDs are not similar assets because:

- The risk characteristics between the PDPs and PUDs are significantly different.
- The presence of two operators with different drilling and completion techniques creates significantly different risk characteristics between the PUDs to be completed by each of the operators.

EXAMPLE 2-4: ACQUISITION OF AN OPERATING INTEREST IN UNPROVED ACREAGE AND PUDS

FACTS

- Explorers R Us acquires a 100% operating interest in unproved acreage, several hundred PUDs, and PDPs (containing dozens of producing wells), mineral interests, and basic lease production facilities for the proved producing properties.
- The fair value of the unproved acreage and PUDs constitutes approximately 80% and 15%, respectively, of the fair value of the gross assets acquired.
- The basic lease production facilities would decline substantially if removed from the properties.
- No employees or other assets were acquired.

CONCLUSION

Substantially all the fair value of the gross assets acquired is not concentrated within a single identifiable asset or a group of similar identifiable assets and further analysis is required. Explorers R Us must consider whether the assets acquired meet the definition of a business as discussed in Section 3.

ANALYSIS

Explorers R Us first considers the guidance in ASC 805-10-55-5A through 55-5C. It concludes that that the unproved acreage is a single asset in accordance with ASC 805-10-55-5B. In other words, the lease(s) associated with the acreage must be combined with the mineral interests and considered one asset. Also, the lease and related mineral interests for each PUD are combined and considered a single asset.

Explorers R Us concludes that each of the PDPs and the basic lease production facilities are a single asset in accordance with ASC 805-10-55-5B. In other words, the basic lease production facilities are attached to the PDPs and the associated mineral interests and cannot be removed without a significant decrease in utility to or fair value of the tangible assets.

Explorers R Us also concludes that the unproved acreage, PUDs, and PDPs along with the associated basic lease production facilities are not similar. Explorers R Us considers the risk characteristics to be significantly different between the unproved acreage, PUDs, and PDPs because:

- No test wells have yet been drilled in the unproved acreage.
- The unproved acreage covers a different geological zone.

EXAMPLE 2-5: ACQUISITION OF A GAS PIPELINE AND TRANSPORTATION AGREEMENT

FACTS

- Midstream Pipeline Co. (Midco) acquires a gas pipeline, which includes a firm transportation agreement with one producer for 100% of the pipeline's capacity at a fixed price per month.
- After assessing the contract, Midco concludes that the agreement is a lease under ASC 842.
- No employees or other assets were acquired.

CONCLUSION

Midco concludes that substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset (pipeline plus transportation agreement), so the set is not a business.

ANALYSIS

Midco first considers the guidance in ASC 805-10-55-5A through 55-5C. Because the transportation agreement is considered a lease, the intangible asset acquired is considered an in-place lease intangible. Therefore, the pipeline and transportation agreement are a single asset in accordance with ASC 805-10-55-5B.

EXAMPLE 2-6: ACQUISITION OF ROYALTY INTERESTS

FACTS

- Shale Co. acquires a 1/16 royalty interest in 100 PDPs in a single geographic area.
- The PDPs are in the same geological basin and have similar production potential.
- No employees or other assets were acquired.

CONCLUSION

Shale Co. concludes that substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset (royalty interest), so the set is not a business.

ANALYSIS

Shale Co. first considers the guidance in ASC 805-10-55-5A through 55-5C. The PDPs have similar risk characteristics because:

- They are in a single geographic area.
- They are in the same geological basin and have similar production potential.

Therefore, the royalty interests in each of the PDPs represent a single group of identifiable assets. The fair value of the assets acquired is concentrated in a single identifiable group of assets, so the acquisition of royalty interests is a single asset in accordance with ASC 805-10-55-5B.

3. Elements of a Business

FASB REFERENCES

ASC 805-10-55-3A through 55-5

If an oil and gas entity concludes that substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the acquisition is as an asset acquisition. However, if substantially all the fair value is not concentrated in a single asset or group of similar assets, the entity must assess whether the acquired set meets the definition of a business.

ASC 805-10-55-3A defines a business as "*an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants*." A business typically consists of inputs and processes applied to those inputs that can contribute to the creation of outputs, and ASC 805 defines those three elements as follows:

- **Input**: Any resource that creates or has the ability to contribute to the creation of outputs when one or more processes are applied to it. Examples include long-lived assets, intellectual property, and employees.
- **Process**: Any system, standard, protocol, convention, or rule that when applied to an input or inputs, creates or has the ability to contribute to the creation of outputs. Examples include strategic, operational, or resource management processes, and can be represented by an organized workforce. Administrative systems such as accounting, billing, and payroll are typically not processes used to create outputs.
- **Output**: The results of inputs and processes applied to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues.

SEC DEFINITION OF A BUSINESS IS DIFFERENT

The definition of a business for SEC reporting is different from that in ASC 805, so SEC registrants must evaluate whether an acquisition constitutes a business under both definitions. Generally, acquisitions of an interest in producing properties are considered a business under Regulation S-X, Rule 11-01(d) (see BDO's publication, Financial Statements of Acquired Businesses: A Snapshot). Therefore, an entity may reach different conclusions for SEC reporting.

Although many acquisitions include all three elements of a business, not all do. To be considered a business, an acquired set must include both inputs and processes. Although a set is not required to include all the inputs or processes needed to operate the business, it must at a minimum include an input and a substantive process that together significantly contribute to the ability to create outputs.

3.1 ELEMENTS OF A BUSINESS IF THE ACQUIRED SET DOES NOT INCLUDE OUTPUTS

FASB REFERENCES

ASC 805-10-55-5D

While businesses usually have outputs, outputs are not required for an integrated set to qualify as a business. However, the criteria for concluding that an acquired set is a business are more stringent when outputs are not present. Specifically, if the set does not include outputs, it must include employees that form an organized workforce and another input (that is, an input other than employees) that the workforce could develop or convert into outputs. The organized workforce must have the necessary skills, knowledge, or experience to convert the acquired inputs into outputs. That may be the result of sufficient knowledge, skills, or experience to develop inputs such as intellectual property; technology; in-process research and development; real estate; or other resources, including mineral interests.

BDO INSIGHTS: DETERMINING WHETHER ORGANIZED WORKFORCE HAS BEEN ACQUIRED

Acquisitions of predominantly unproved properties or PUDs generally lack outputs. Therefore, acquirers must consider whether an acquired workforce (if any) is capable of developing the acquired mineral interests into producing wells. For example, if an entity acquires a group of unproved properties and the seller accepts employment with the acquirer to help identify and acquire additional properties, that set would likely not meet the definition of a business because the sole acquired employee does not have the requisite skills or experience to develop the unproved properties. Alternatively, had the acquired set included employees, such as petroleum engineers and geologists who were actively engaged in developing the properties, it would likely meet the definition of a business. If acquisition of unproved properties or PUDs does not include an organized workforce, it is an asset acquisition (see Section 4). Determining whether an entity has acquired an organized workforce requires the use of professional judgment based on the facts and circumstances.

3.2 ELEMENTS OF A BUSINESS IF THE ACQUIRED SET INCLUDES OUTPUTS

FASB REFERENCES

ASC 805-10-55-5E through 55-5F

When evaluating whether an acquired set with outputs is a business, **any** of the following would represent a substantive process:

- Employees who form an organized workforce with the necessary skills, knowledge, or experience to perform an acquired process that when applied to the acquired input or inputs is critical to the ability to continue producing outputs
- An acquired contract that provides access to such an organized workforce
- An acquired process that cannot be replaced without significant cost, effort, or delay
- An acquired process that is unique or scarce

On its own, continuation of revenues does not indicate that both an input and a substantive process have been acquired; for example, when assumed contractual arrangements such as customer contracts, customer lists, or leases provide for the continuation of revenues.

Generally, the acquisition of producing properties that fails the screen test will meet the definition of a business because the acquired set will include inputs and a substantive process that together significantly contribute to the ability to continue producing outputs (for example, owned or leased mineral rights, an organized workforce or JOA, and infrastructure equipment).

BDO INSIGHTS: WHAT CONSTITUTES A SUBSTANTIVE PROCESS

If an acquisition of oil and gas PDPs does not meet the screen test because the PDPs are not sufficiently similar so that substantially all the fair value of the gross assets acquired is not concentrated in a single group of similar assets, the acquirer must determine whether it has acquired a substantive process.

Many entities that invest in oil and gas PDPs operate those properties through JOAs. Although JOAs include administrative processes, such as accounting and billing, they also include operational and strategic management processes, such as a plan of operations for drilling and development and a named operator in charge of supervising the properties. We believe that from a nonoperator's perspective, the existence of a JOA would generally meet the definition of a substantive process in accordance with ASC 805. Specifically, a JOA represents a contract that will often give the acquirer access to an organized workforce that can operate the PDPs to continue producing outputs.

Further, we believe a group of PDPs includes a process facilitated by the well production equipment that significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost.

Therefore, we believe that an acquired group of PDPs will generally meet the definition of a business if it does not meet the screen test.

BDO INSIGHTS: SCADA SYSTEMS INDICATE THE PRESENCE OF A SUBSTANTIVE PROCESS

Midstream oil and gas entities gather, process, store, and transport oil and gas. Acquisitions completed by such entities often include pipelines, processing equipment, storage tanks, in-place lease intangibles, and supervisory control and data acquisition (SCADA) systems. We believe SCADA systems indicate that a substantive process was acquired because they contribute to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay.

BDO INSIGHTS: ACQUISITIONS OF PRODUCING AND NONPRODUCING PROPERTIES

Acquisitions routinely include a mixture of producing and nonproducing properties. ASC 805 is silent regarding scenarios in which the set includes a significant asset with outputs and another significant asset without outputs. We believe that when an acquired set includes producing properties, the analysis should be performed in accordance with the guidance in Section 3.2. However, if the value of the producing properties is a clearly insignificant component of the overall value of the acquired set, the analysis should be performed in accordance with the guidance in Section 3.1.

3.3 ELEMENTS OF A BUSINESS: EXAMPLES

FASB REFERENCES

ASC 805-10-55-3A through 55-5

Examples 3-1 through 3-5 illustrate the application of the definition of a business.

EXAMPLE 3-1: ACQUISITION OF A NONOPERATING INTEREST IN PROVED AND UNPROVED PROPERTIES

FACTS

- Exploration and Production Co. (E&P Co.) acquires a 50% nonoperating interest in proved properties, which contain several hundred PDPs, dozens of PUDs, the related mineral interests, basic lease production facilities, and two joint operating agreements with two separate operators with different drilling and completion techniques.
- The assets acquired are not in a legal entity. E&P Co. also determines that it has obtained control of the assets acquired.
- The fair value is split pro rata between the two operators, and the PDPs do not constitute substantially all the fair value of the gross assets acquired in the set.
- The basic lease production facilities would decline substantially if removed from the properties.
- No employees or other assets were acquired.

CONCLUSION

The acquired set is a business because the acquired set includes inputs, processes, and outputs.

ANALYSIS

The set includes inputs: the acquired PDPs, PUDs, mineral interests, and basic lease production facilities.

Because the set has outputs (production from the several hundred PDPs), E&P Co. must consider the guidance on elements of a business that includes outputs (see Section 3.2). E&P Co. did not acquire a workforce, but the JOA provides access to the operators' organized workforce that is critical to the ability to continue to produce outputs. Also, the set includes a process facilitated by the lease production infrastructure that significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost. Therefore, E&P Co. concludes that the set is a business.

EXAMPLE 3-2: ACQUISITION OF AN OPERATING INTEREST IN UNPROVED ACREAGE AND PUDS

FACTS

- Explorers R Us acquires a 100% operating interest in unproved acreage, several hundred PUDs, and PDPs (containing dozens of producing wells), mineral interests, and basic lease production facilities for the proved producing properties.
- The fair value of the unproved acreage and PUDs constitutes approximately 80% and 15%, respectively, of the fair value of the gross assets acquired.
- The basic lease production facilities would decline substantially if removed from the properties.
- No employees or other assets were acquired.

CONCLUSION

The acquired set is not a business because the acquired set does not include an organized workforce.

ANALYSIS

Although the set has outputs, Explorer R Us concludes that most of the value resides in the unproved properties and PUDs that contain no outputs and therefore considers the guidance on elements of a business that does not include outputs (see Section 3.1). While the acquired set includes inputs (unproved acreage, PUDs, PDPS, mineral interests, and basic lease production facilities), Explorers R Us concludes it did not acquire an organized workforce and that the set is therefore not a business.

EXAMPLE 3-3: ACQUISITION OF A GAS PIPELINE AND TRANSPORTATION AGREEMENT

FACTS

Assume same facts as Example 2-5, except that Midco acquires firm transportation agreements with two producers, neither of which control the pipeline, for 100% of the pipeline's capacity.

CONCLUSION

The acquired set is not a business because it does not include a substantive process.

ANALYSIS

Because neither producer controls the pipeline, Midco concludes that the agreements are not leases under ASC 842. Therefore, the acquired set includes a pipeline and two customer relationship intangible assets.

Midco must first consider whether the screen test is met. As discussed in Section 2.1, tangible and intangible assets are not similar assets. Therefore, the pipeline and customer relationships are not similar, and substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset. Midco concludes that the set does not meet the screen test.

Midco must then determine if the acquired set includes both an input and a substantive process that together significantly contribute to the ability to create an output. Because the set contains outputs (pipeline revenue), Midco must consider guidance on an acquired set that includes outputs (see Section 3.2). Midco concludes that it did not acquire a significant process. Specifically, Midco did not acquire a workforce or a contract that provides access to a workforce. Midco intends to use its own workforce to operate the pipeline, and it acquired no other processes.

Although the firm transportation agreements provide for a continuation of revenue, Midco does not factor them into its analysis of whether a process was acquired. Midco concludes that the acquired set is not a business.

EXAMPLE 3-4: ACQUISITION OF PDPS AND A PROCESSING PLANT

FACTS

- Drilling & Refining Co. (D&R) acquires a 75% operating interest in PDPs containing several hundred producing wells, including the mineral interests, basic lease production equipment, and a processing plant (that is also processing third-party volumes).
- The fair value of the processing plant constitutes approximately 60% of the fair value of the gross assets acquired.
- Employees associated with the management of the processing plant were included in the acquired set.

CONCLUSION

The acquired set is a business because it includes inputs and substantive processes.

ANALYSIS

D&R considers the screen test and concludes that the PDPs and processing plant are not similar assets because they are in different major asset classes and have significantly different risk characteristics as the processing plant is also processing third-party volumes. D&R concludes that the screen test is not met.

D&R must therefore determine if the acquired set includes both an input and a substantive process that together significantly contribute to the ability to create an output. Because the set contains outputs (production from the PDPs and revenues from processing), D&R must consider the guidance on an acquired set that includes outputs (see Section 3.2).

Although D&R did not acquire a workforce associated with the PDPs, it did acquire a workforce associated with the processing plant. Therefore, D&R concludes that the workforce acquired is critical to the ability to continue to produce outputs and that the set is thus a business. Also, the set includes a process facilitated by the lease production equipment and processes associated with the processing plant that significantly contribute to the ability to continue producing outputs and cannot be replaced without significant cost.

EXAMPLE 3-5: ACQUISITION OF ORRIS

FACTS

- Shale Co. acquires a 2% ORRI in 100 oil PDPs in Texas and Oklahoma.
- The PDPs are in different geological basins and have different production potential.
- The ORRI does not meet the definition of a lease.
- The fair value of the ORRI in the Oklahoma PDPs constitutes 70% of the fair value of the gross assets acquired. The remaining 30% of the fair value is concentrated in the ORRI in the Texas PDPs.
- No employees or other assets were acquired.

CONCLUSION

The acquired set is not a business because the acquired set does not include a substantive process.

ANALYSIS

Shale Co. considers the screen test and concludes that the ORRI in PDPs in Texas and Oklahoma are not similar assets because they have significantly different risk characteristics given the different geological basin locations and production potential. Shale Co. concludes that the screen test is not met.

Shale Co. must therefore determine if the acquired set includes both an input and a substantive process that together significantly contribute to the ability to create an output. Because the set has outputs (production from PDPs), Shale Co. must consider the guidance on elements of a business that includes outputs (see Section 3.2).

Shale Co. did not acquire a workforce associated with the producing wells or any processes. Therefore, it concludes the ORRI acquisition does not meet the definition of a business.

4. Accounting for an Asset Acquisition

FASB REFERENCES
ASC 805-50

If an acquisition meets the screen test or fails the screen test and does not have the required elements of a business, it must be accounted for as an asset acquisition in accordance with ASC 805-50, *Business Combinations — Related Issues*. The table below summarizes a few of the more significant differences between an asset acquisition and a business combination. See Appendix C in BDO's Blueprint, [Business Combinations Under ASC 805], for more guidance on asset acquisitions.

	ASSET ACQUISITION (OTHER THAN THE INITIAL CONSOLIDATION OF A VARIABLE INTEREST ENTITY THAT IS NOT A BUSINESS)	BUSINESS COMBINATION
General Principle	**Cost Accumulation Model:** The cost of the acquisition (which includes transaction costs) is allocated to the acquired assets and liabilities, generally based on relative fair values. As a result, the acquired assets may not be recognized at fair value.	**Fair Value Model:** Assets acquired and liabilities assumed are accounted for at fair value with limited exceptions.
Goodwill	An asset acquisition does not give rise to goodwill.	The acquirer recognizes goodwill if the consideration transferred plus the fair values of any noncontrolling interest and previously held equity interests exceeds the acquired net assets.
Acquisition-Related Costs or Transaction Costs	Transaction costs are included in costs capitalized for an asset acquisition.	Acquisition-related costs are not part of the fair value exchange between the buyer and seller. As a result, acquisition-related costs incurred for a business combination must be expensed as incurred.
Measurement Period	In an asset acquisition, there is no concept of a measurement period, regardless of the size and complexity of the transaction.	In a business combination, the acquirer has up to one year after the acquisition date to finalize its accounting for the business combination. That measurement period allows the acquirer time to obtain the information necessary to identify and measure the various elements of the business combination.

Appendix A: Other BDO Publications

BDO's Professional Practice — Accounting Group has issued the following Blueprints, which provide detailed accounting guidance, interpretive insights, and practical examples on complex areas of U.S. GAAP:

- Issuer's Accounting for Complex Financial Instruments
- Equity Method Investments Under ASC 323
- Revenue Recognition Under ASC 606
- Share-based Payments Under ASC 718
- Business Combinations Under ASC 805
- Control and Consolidation Under ASC 810
- Accounting for Leases Under ASC 842

BDO's Professional Practice — SEC Services Group has issued the following Blueprints to help SEC registrants apply the SEC's rules and regulations related to financial reporting:

- Guide to Going Public

Series Overview: Building Knowledge

In addition to Blueprints, BDO's Professional Practice has issued a suite of publications related to U.S. GAAP and SEC rules and regulations:

- Bulletins: short, timely communications delivering essential news, alerts, and developments in accounting and SEC reporting
- Snapshots: summaries of SEC rules and regulations
- SEC Reporting Insights, updated annually
- Conference Highlights: Current SEC & PCAOB Developments, updated annually
- Effective Date Reminders, updated annually
- Industry Supplements
- Other publications on new accounting standards and SEC rules and regulations.

For more on IFRS, visit BDO's IFRS and Corporate Reporting for more information.

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