

ISSUING  
 ORG. ACCOUNTING POLICIES & SYSTEMS DEPARTMENT  
 SUBJECT **EXPLORATION COSTS**

|                        |                      |
|------------------------|----------------------|
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**CONTENT:** This instruction covers the accumulation and accounting of costs related to Exploration. The text of this instruction includes:

1. References
2. Background and Policy
3. Accumulating and Accounting for Exploration Costs
4. Abu Sa'fah Exploration Costs
5. Roles and Responsibilities

Appendix 1 – Background on Government and Financial Policy

## 1. **REFERENCES**

### 1.1 ABBREVIATIONS & ACRONYMS

|        |   |                                                                    |
|--------|---|--------------------------------------------------------------------|
| AAU    | - | Assets Accounting Unit/P&FAAD                                      |
| AP&CD  | - | Accounting Policies & Controls Division/AP&SD                      |
| AP&SD  | - | Accounting Policies & Systems Department                           |
| AUC    | - | Assets Under Construction                                          |
| BI     | - | Budget Item                                                        |
| CPD    | - | Capital Programs Division/FAD                                      |
| E&E    | - | Exploration and Evaluation                                         |
| ECC    | - | Exploration Computer Center                                        |
| EP&PM  | - | Exploration Planning & Performance Management Division/Exploration |
| FAD    | - | Financial Accounting Department                                    |
| FP&PM  | - | Finance, Planning & Performance Management Division/UR             |
| FR&TCD | - | Financial Reporting and Tax Compliance Division/FAD                |
| G&G    | - | Geological and Geophysical                                         |
| GI     | - | General Instruction                                                |
| GL     | - | General Ledger                                                     |
| PAU    | - | Projects Accounting Unit/P&FAAD                                    |
| PEG    | - | Period End Group/AP&CD                                             |
| P&FAAD | - | Project & Fixed Assets Accounting Division/FAD                     |
| PP&E   | - | Property, Plant and Equipment                                      |
| SAP AM | - | SAP Asset Management Modules                                       |
| UR     | - | Unconventional Resources                                           |
| WBS    | - | Work Breakdown Structure                                           |

### 1.2 RELATED INSTRUCTIONS

|        |   |                                 |
|--------|---|---------------------------------|
| AI 125 | - | Abu Sa'fah Production Costing   |
| AI 210 | - | Well Suspension and Abandonment |

|                                                                               |                                          |                                            |                      |
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GI 20.081 - Exploration Program and Budget  
 GI 216.608 - Well Accounting  
 GI 287.005 - Capital Expenditure Recoveries

### 1.3. REPORTS

AR-187 - Appropriation – Exploratory Drilling and Development Costs

### 1.4. DEFINITIONS

**Directly Attributable Costs** – Direct costs to bring an asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

**E&E Phase** – Denotes the stage where activity is taking place on an unproven property. E&E phase ends once technically and commercially viable reserves are identified.

**Exploration Costs** – Costs incurred to explore unproven property for potential hydrocarbon reserves or to determine the limits of proven properties. It includes both G&G Costs and exploratory drilling costs.

**G&G Costs** – All costs directly related to performing geological and geophysical studies.

## 2. BACKGROUND AND POLICY

### 2.1. EXPLORATION ACTIVITY

Exploration is defined as any activity undertaken to explore unproven property for potential hydrocarbon reserves or to determine the limits of existing proven properties. Exploration activity includes the drilling of exploratory wells and performing G&G studies in order to identify potential areas or explore specific areas. Exploration Costs for conventional resources, including G&G costs, staff support, and well costs, are budgeted for under BI 33. BI 34 is used to budget similar costs for unconventional resources. Refer to GI 20.081 "Exploration Budget and Program" and GI 20.500 "Expenditure Requests" for more information about the BI 33 budgeting process.

### 2.2. ACCOUNTING POLICY FOR EXPLORATION COSTS

Saudi Aramco accounts for its E&E costs using the 'successful efforts' method. Under this method, Exploration Costs which can be directly allocated to commercially and technically viable hydrocarbon reserves are capitalized. In practice, this means that many non-drilling costs (such as G&G Costs) and exploratory dry holes are expensed while successful exploratory wells and their Directly Attributable Costs are capitalized. If exploratory wells

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that are suspended cannot demonstrate sufficient progress in evaluation, then the costs initially capitalized are expensed. Please refer to AI 210 – Well Suspension and Abandonment for further details.

### **3. ACCUMULATING AND ACCOUNTING FOR EXPLORATION COSTS**

#### **3.1. WBS ACCOUNTS**

Exploration Costs for BI 33 and BI 34 are charged to and accumulate in WBS accounts. These accounts have a type prefix, which indicate a broad category of cost, and a suffix (phase or sub-item number) which relates to a more specific type of cost.

Conventional Exploration Costs are accumulated in type prefix 75 accounts for exploratory well costs and type prefix 33 accounts for all other costs (seismic surveys, G&G Costs, and staff support) associated with exploration.

Unconventional Exploration Costs are accumulated in type prefix 85 accounts for exploratory well costs and under the following unique WBS structures for other (seismic surveys, G&G Costs, and staff support) costs:

|          |         |
|----------|---------|
| 34-XX200 | Seismic |
| 34-XX300 | Support |

(Note: the figures represented by 'XX' are updated with each new BI)

Charges to the WBS accounts are made in one of two ways:

- Direct charges to individual WBS are incurred costs that are specifically identified to an individual project such as for materials and services charged to a G&G survey program. Materials are recognized when they are received through the execution of goods receipts and services are recognized through the execution of service entry sheets and other invoice documents.
- Reallocated costs are costs that are directly related to exploration activities and their administration which cannot be directly charged to a specific project (e.g. the costs of a geophysicist working on several G&G studies). These costs are reallocated to relevant WBS' from internal cost centers via SAP assessment cycles. Directly Attributable Costs eligible for capitalization as part of a well cost are also reallocated using these cycles.

The SAP assessment cycles and their related journal entries are posted automatically at month end. Each cycle typically has 6 segments covering the reallocation of the following

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cost categories: Labor, Material, Services, Depreciation, Support Services and Miscellaneous. Only the segments which are determined as applicable will be included in the reallocation. SAP assessment cycles are dynamic and the proponent is responsible for updating PEG for any changes in allocations on an annual basis, consistent with their business plan submissions. PEG can be contacted for the latest set of assessment cycles.

For further detail on SAP assessment cycles and the reallocation of Exploration Costs, please refer to GI 287.005 – Capital Expenditure Recoveries.

### 3.2. ACCOUNTING FOR EXPLORATION COSTS

#### 3.2.1. G&G Costs

G&G direct and reallocated costs as described in section 3.1 above, are charged to the relevant WBS accounts and expensed as G&G costs incurred in the E&E phase. The expensing process is through the SAP AM module which creates an asset class for the G&G costs and amortizes the G&G asset based on a one month useful life, effectively expensing 100% of the cost in the month it is incurred in the following steps:

- G&G costs are automatically capitalized in GL account 2008025 through SAP settlement rule in phase 998 of the Type Prefix 33 and 34 WBS accounts.
- An asset record is created for every WBS account under asset class 38021-00
- The asset is fully amortized, crediting GL account 2058030 "Accumulated Amortization Exploration – Current Year" and debiting GL account 7405218 – "G&G Expense" in the relevant proponent cost center.

Creating a G&G asset in SAP AM module allows amortized costs for tax deduction purposes to be calculated in the system.

Development G&G costs for conventional activity related to the development of certain fields are charged to Type Prefix 66 development well accounts and capitalized accordingly.

#### 3.2.2. Capitalization of Exploratory Wells

Exploratory wells are initially capitalized as AUC in SAP under the following GL accounts:

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|                                                    |         |
|----------------------------------------------------|---------|
| Incomplete Unconventional Wells – Tangible         | 2045011 |
| Incomplete Unconventional Wells – Intangible       | 2045012 |
| Incomplete Conventional Wells – Intangible (Crude) | 2045013 |
| Incomplete Conventional Wells – Intangible (Gas)   | 2045014 |
| Incomplete Conventional Wells – Tangible           | 2045004 |

The well costs are transferred to the fixed asset register when evaluation of the well ends and a development decision is taken by the Upstream Business Line and the well is ready for use as detailed in GI 216.608 "Well Accounting".

If the drilling is deemed unsuccessful, the well cost is expensed as a dry hole. Refer to AI 210 Well Suspension and Abandonment for further information on writing off dry holes.

### 3.2.3. Exploratory Support Costs

Exploratory support costs represent costs directly related to exploration activities and their administration that cannot be linked to a specific project. They are charged to relevant exploration WBS' based on SAP assessment cycles as described in section 3.1 above.

## 4. **ABU SA'FAH EXPLORATION COSTS**

Abu Sa'fah is an offshore oil field whose production is shared with the Kingdom of Bahrain. Exploration costs for Abu Sa'fah under the expansion project agreement between the Kingdom of Saudi Arabia and the Kingdom of Bahrain effective in 2002 were added to the cost of the expansion project, which was 50% financed by the Kingdom of Bahrain. The expansion project was completed in the 3<sup>rd</sup> quarter of 2004. Exploration costs and development seismic costs specific for Abu Sa'fah require separate WBS and asset records assigned to Abu Sa'fah cost centers to capture their exploration costs and the amortization of development seismic costs in the production unit cost calculation of the Abu Sa'fah field. Unallocated Exploration Organization and ECC costs, which are expensed, in general are indirectly shared by Abu Sa'fah field through an allocation process. Refer to AI 125 – Abu Sa'fah Production Costing for further information.

## 5. **ROLES AND RESPONSIBILITIES**

### PAU

- Unblock, close, and maintain Type Prefix 33, 34, 75 and 85 WBS accounts and all associated settlement rules.

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AAU

- Maintain Asset Class 38021-00.
- Reconcile GL accounts with assets sub ledger accounts.

CPD

- Create the first level of WBS structure in SAP upon the approval of the Expenditure Request for BI 33 and BI 34.
- Monitor BI 33 and BI 34 budget versus actual expenditures.

FR&TCD

- Monitor compliance with Government income tax guidelines and Company reporting standards.

FP&PM

- Prepare annual BI 34 budget.
- Prepare monthly BI 34 MIS and accountability reports.
- Create and maintain the coding for type prefix 34 WBS accounts under BI 34 WBS structure to capture G&G costs.
- Create and maintain the coding for well accounts under BI 34 WBS structure to capture costs of exploratory wells (including exploratory water wells).
- Review and document activity of the UR Organization to ensure the assessment cycle allocation of their directly related costs are reasonable.

EP&PM

- Prepare annual BI 33 budget.
- Prepare monthly BI 33 MIS and accountability reports.
- Create and maintain the coding for Type Prefix 33 WBS accounts under BI 33 WBS structure to capture G&G costs.
- Create and maintain the coding for Type Prefix 75 and 63 WBS accounts under BI 33 WBS structure to capture costs of exploratory wells (including exploratory water wells.)
- Review and document activity of the Exploration Organization to ensure the assessment cycle allocation of their directly related costs are reasonable.

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AP&SD

- Maintain assessment cycles.
- Add new cost centers and cost center groups upon request.
- Prepare and update accounting policy guidelines as necessary.

Approved: \_\_\_\_\_

**Abdulaziz A. Al-Ruwaii**, Manager  
Accounting Policies & Systems Department

NAK

\* CHANGE

\*\* ADDITION

NEW INSTRUCTION ☐

COMPLETE REVISION ☐

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## Appendix 1 – Background on Government & Financial Policy

For income tax purposes, the Saudi Arab Government, per Royal Decree 51, dated March 26, 1963 permitted the deduction of exploration (seismic surveys, geophysical/geological studies/staff support) costs of the greater of a) 5% of total exploration costs (not to exceed 100% of original cost), or b) total exploration costs, less any deductions previously taken divided by the number of years remaining in the term of the concession. The date the concession was due to expire was July 14, 1999.

Until 1980, Aramco deducted exploration costs in full for the financial statements, which resulted in a difference in financial and tax income. In 1980, Aramco adopted the income tax method for financial statements. During the period 1987 through 1989, Saudi Aramco began amortizing exploration costs over the remaining life of the concession. In 1989, Saudi Aramco started amortizing exploration costs over 20 years, recognizing that as a state-owned oil company, rights to crude oil production will not stop at the end of the concession agreement. Effective January, 2005, the useful life of exploration costs was revised from 20 years to 15 years to standardize the amortization policy for all intangible assets.

In 2016, as part of a wider shift to the successful efforts method of accounting for oil and gas activity, an accounting policy was adopted to expense all G&G costs related to the E&E Phase of discovering hydrocarbons. Exploratory drilling costs continue to be capitalized if the well is successful. The useful life for intangible drilling costs was reviewed and changed to reflect the expected life of the field's underlying reserves. Tangible assets retained their original useful lives. Please refer to GI 202.301 for a detailed list of asset useful lives.

Effective January 1, 2016 a tax policy was also adopted for exploration costs (including G&G), where for tax purposes they are capitalized and amortized in line with tax amortization rates.

\* CHANGE

\*\* ADDITION

NEW INSTRUCTION ☐

COMPLETE REVISION ☒