

## **Scenario #2: Allocation of Field Costs: An Audit Dispute**

**THE ISSUE:** An audit has been performed by Company A on joint lands and facilities which are operated by Company B. Company A has done the audit on behalf of several other partners in the wells and Plant. The audit was done in April 2002 for previous fiscal year. When the area was first developed (1992), the wells and Plant were generally in the same working interests (50% Company B, 35% Company A; 15% divided by 3 other owners). Since then, there have been wells drilled by the different companies at varying working interests including 100% wells by each of the two main parties. Companies with no interest in the Plant are also now producing in the area and the production is being processed at the Plant. Company B has a policy where any wells coming into their facility must be operated or contract operated by them. The audit appears to suggest that the proceeds from operations are no longer being shared equitably.

### **Initial Assessment & Cost Benefit Analysis**

Applying the elements of this case study to your own issue, consider the following analysis and questions (see the Cost Benefit Analysis worksheet in the next section):

- What are the issues that are having a major impact on your company? What additional information do I need?
- What are *all* the costs of these issues as they continue to go unresolved – including permanent damage to the business relationship?
- What value can be attributed to the issues if they are resolved?
- What has happened to date? What has been successful in resolving the outstanding issues?
- What in the way of direct consultation with the other companies involved has occurred?

### **COMPLICATING FACTORS:**

Some field costs (salaries, vehicle costs, field office costs) for the area are allocated to the wells in the area. There is a difference of opinion on what should be included and what is a reasonable method to allocate the charges to each location. The allocation of charges based on the number of wells does not, in the auditor's opinion, reflect the actual use of resources and the auditor noted that the allocation was not updated on a regular basis to reflect changing field operations. The auditor cited several examples where Company B neglected to account for changes in well status. (e.g. wells put on production, well shut in). Company B believed the charges were allocated correctly although the charge out may not be appropriately weighted and ownership in the wells may vary. While these kinds of issues can be corrected (and often are) on a go forward basis, Company B was reluctant to adjust the items retroactively due to the time/cost involved. Also, Company B believed that from the Operator's perspective, all costs had been recovered (albeit perhaps not from the right parties) and expected the end result might not be "material".

Company A felt the product allocation methodology at the plant was fundamentally incorrect and while the actual value of the discrepancy was hard to quantify, had expressed this concern to Company B on several occasions prior to the audit. Company A requested the auditor to investigate this concern in the course of the audit. To demonstrate the nature of the problem, the auditor selected a sample day to extrapolate

the potential value. On the face of it each example was dismissed by Company B as being immaterial, and the audit exception inconsequential. As such the underlying issue has still not been addressed.

The Operator (Company B) retains many consultants rather than hiring full-time employees. The governing agreement sets out those charges which require approval and those which are not. Although some of these costs may legitimately be charged out to partners, the auditor's past experience has been that some operators are quite aggressive in coding costs to the joint account, suggesting that if raised under audit they would look at the exceptions on a case by case basis. This approach leaves room for differing opinions on what an operator can directly charge vs what would be covered by its overhead. The auditor's initial response to these types of issues was to request credits on all the charges on the basis that no specific approval was sought from the owners prior to charging the costs to the joint account.

At the facility level, Company B has entered into an Engineering Alliance with a third party engineering firm to do all their facility engineering for the plant and the gas gathering system. There was a major plant expansion in the summer of 2001 and the auditor is questioning the validity of the engineering costs associated with this project. The governing agreement sets out those engineering costs that are directly chargeable and those which the Operator recovers via its overhead. The auditor has identified costs for work that had it been performed by the Operators staff would not have qualified as being directly charged to the project and has raised an audit exception. Company B responded that other provisions of the agreement allow it to charge third party costs directly to the project (and partners), regardless of the type of work performed.

### **Resolution Potential & Options**

Out-of-date accounting methodology and differing interpretations of contracts are indications of *systemic* problems (conflict) in the corporate relationship that will continue to generate disputes and issues until they are addressed. Applying the elements of this conflict to your own situation, consider the following analysis and questions in selecting your resolution options:

- Other than the threat of litigation, what incentive does the other party to your dispute have for settling the outstanding issue or issues? How many parties must be in agreement for resolution to occur?
- What do your technical experts (i.e. auditors) agree upon? How do they differ?
- What incremental technical change to your business arrangement could be made that would lead to resolution OR what fundamental changes in the relationship are needed to avoid further dispute on these issues?

**APPROPRIATE DISPUTE RESOLUTION:** In this case, application of technical accounting methodologies and differences in corporate operations were indicative of business relationships in need of attention and renewal.

After assessing the outstanding issues in dispute and projecting the potential costs to Company A's operations if these issues went unresolved, the responsible Company A manager contacted his Chief Operating Officer (COO) with a recommendation that legal action be taken to recover lost revenues and enforce needed changes to the accounting methodologies. On consulting with the company's legal department, Company A's COO

was advised that recovery of costs may be a long, complex and expensive undertaking, requiring significant human resources to be assigned, as well as technical consultants.

As an alternative, Company A's COO set up a golf date with his CEO and Company B's Chief Financial Officer and VP of Operations. Between shots, the four discussed the historic relationship between the companies and the on-going issues that were causing growing friction. Recognizing the basically technical nature of the problem – inflamed by the addition of other companies and changes in human resource management practices, the executives agreed to have an independent, mutually agreed upon auditor review methodologies and the distribution of field costs, and make recommendations on potential accounting changes and/or compensation.

While the auditor reviewed the financial arrangements, operating managers were jointly tasked with the review of contracting procedures.

**Incremental progress was made in this regard, and the major issue in contention remained B. Co.'s use of contract employees charged against operations without prior approval of the partners. This issue was finally addressed after Company A successfully negotiated collective action with companies holding smaller interests. Several facilitated sessions between all partners resulted in development of a policy with respect to acceptable charges to the operation. Company A did not in the end receive compensation, however the distribution of field costs improved and the level of conflict and the number of issues in dispute significantly declined.**