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Oil & Gas Spotlight

M&A 101 — Understanding Merger and Acquisition Activity in the Current Environment

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E&P companies that enter into M&A transactions need to understand the four fundamental steps to accounting for a business acquisition: (1) identifying the acquirer, (2) identifying the acquisition date, (3) determining the measurement period, and (4) recognizing and measuring the acquisition.

The Bottom Line

- Through the first half of 2013, mergers and acquisitions (M&A) activity appears to have slowed, but it is too early to speculate on whether this trend will continue.
- Exploration and production (E&P) companies must carefully determine whether an M&A transaction represents the acquisition of a business or the purchase of assets.
- E&P companies that enter into M&A transactions need to understand the four fundamental steps to accounting for a business acquisition: (1) identifying the acquirer, (2) identifying the acquisition date, (3) determining the measurement period, and (4) recognizing and measuring the acquisition.
- While most value in a business combination is attributable to oil and gas (O&G) properties and E&P companies generally allocate as much value to hydrocarbons as is allowed under U.S. GAAP, goodwill can still arise regardless of whether such companies use the successful-efforts or full-cost accounting approach. In contrast, some business combinations might result in a bargain purchase by the acquirer, resulting in the need to recognize a gain in the income statement.
- Business acquisitions in the E&P industry often include unique assets that may affect purchase price allocation and the resulting accounting. Important accounting considerations related to purchase price allocation include understanding the nature of the properties (i.e., proved vs. unproved), identifying intangible assets in the transaction, and accounting for income taxes in a business combination.

Beyond the Bottom Line

In September, Deloitte's O&G practice hosted another in its series of industry roundtables in Houston, Texas. During this event, Deloitte's Jed Shreve gave an overview of the upstream M&A activity that has occurred in the O&G industry during 2013. Similarly, Deloitte's Phillip Hilsher discussed some of the more relevant provisions of business combination accounting that would be applied when a company acquires another business. These discussions were moderated by Paul Horak, Deloitte's U.S. AERS O&G audit leader.

This *Oil & Gas Spotlight* provides an update on M&A activity in the E&P sector of the O&G industry throughout 2013. In addition, it contains a high-level overview of the accounting for business acquisitions by (1) highlighting certain nuances that distinguish a business from an asset, (2) discussing the steps in accounting for a business acquisition, and (3) emphasizing certain considerations related to purchase price allocation.

Merger and Acquisition Activity

Oil and Gas Industry M&A Activity

While companies formerly seemed to consider oil, natural gas, and natural gas liquids as a whole when developing their M&A strategies, the new strategy appears to be to look at each product individually.

The United States continues to be the largest market for O&G M&A activity, with U.S. transactions accounting for approximately 46 percent of global deals. Similarly, North America seems to be a hotspot for M&A activity, accounting for about two-thirds of all transactions.

However, through the first half of 2013, M&A activity seems to have slowed both in the O&G industry and throughout the world. Some cite challenges in accessing capital markets as one of the root causes, while others believe the cause to be weaker global economic conditions. Still others believe that the strong push to complete transactions during the final quarter of 2012 may have affected M&A activity in the first part of 2013 (i.e., the 2012 transactions "borrowed" some of the activity that may have otherwise taken place during 2013).

The composition and nature of M&A transactions have also changed. After years of risk taking, buyers seem to be shifting toward more conservative transactions involving oil-producing assets that have already been developed. In addition, buyers' business expansion approaches are focusing more on asset acquisition than on corporate acquisition. For example, for the first half of 2013, in deal value, 39 percent of O&G transactions were corporate acquisitions and 61 percent were asset acquisitions, compared with 55 percent and 45 percent, respectively, for the same period in 2012.

Further, while companies formerly seemed to consider oil, natural gas, and natural gas liquids as a whole when developing their M&A strategies, the new strategy appears to be to look at each product individually. It appears that companies are currently more bullish on the acquisition of oil assets and bearish on gas assets, including those related to natural gas liquid operations.

Spotlight on Upstream M&A Activity

For the first six months of 2013, one area of M&A activity in which transactions significantly declined is upstream deals. While transactions in North America continue to account for much of the upstream M&A activity, the number and value of deals in this region have significantly decreased since 2012. For example, through the first half of 2013, E&P transaction deal values fell to about $43 billion, a decrease of about 44 percent (while the number of deals decreased by 48 percent, from 263 in the first half of 2012 to 162 in the first six months of 2013). This decrease could indicate that interest in North American unconventional resources is waning or that E&P companies are shifting their focus from acquiring additional properties to developing properties that they had previously acquired.

Upstream M&A transaction activity has declined in Canada as well but at a more significant rate (31 deals in the first half of 2013 compared with 72 in the first half of 2012). Reasons for this decrease may include reduced interest by U.S. investors and regulatory changes that are making it more difficult for national oil companies to buy assets in Canada.

For additional details, see Deloitte's July 2013 publication *Deloitte Oil & Gas Mergers and Acquisitions: A Subdued Deal Market Follows Brisk End-of-Year Activity*.

Acquisition Accounting — What You Need to Know

Acquiring a Business Versus Purchasing an Asset

For a business acquisition to take place, the transaction must include a business. ASC 805[1] defines a business as "[a]n 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 therefore must possess **all** of the following characteristics:

- Inputs.
- Processes applied to those inputs.
- Resulting outputs to generate revenues.

However certain transactions that have such characteristics would not be considered a business acquisition and would be precluded from acquisition accounting. Such transactions include (1) the formation of a joint venture, (2) the acquisition of an asset or a group of assets that does not meet the definition of a business, or (3) a combination between entities under common control.

E&P companies continue to enter into M&A transactions. For accounting purposes, some of these transactions are considered a business acquisition and others are classified as an asset purchase.

Accounting for Business Acquisitions and Asset Purchases

As discussed earlier, E&P companies continue to enter into M&A transactions. For accounting purposes, some of these transactions are considered a business acquisition and others are classified as an asset purchase. Understanding the differences between these two transaction types is important to understanding the accounting underlying each type of transaction.

Acquiring a Business

A business acquisition is more complex than an asset purchase and involves the purchase of assets and the assumption of liabilities related to the inputs, processes applied to those inputs, and resulting outputs that generate revenues. The following are common types of business acquisitions in the E&P industry:

- Acquisition of working interest in proved reserves (regardless of whether the working interest is in a producing property).
- Acquisition, in certain circumstances, of net profit interest and royalty interest in proved reserves.
- Acquisition of an entity that generates cash flows to provide a return on investment.

Determination of whether a business has been acquired can be difficult when there are limited amounts of proved working interests as part of a larger unproved property.

[1] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Transactions that constitute a business acquisition are subject to the accounting requirements of ASC 805 under U.S. GAAP. The acquirer records the business at fair value, and there is a purchase price allocation of the consideration paid in the transaction to the assets acquired and liabilities assumed. As a result of the purchase price allocation, the acquirer records goodwill (if the consideration paid exceeds the fair value of net assets acquired) or a gain from a bargain purchase (if the consideration paid is less than the fair value of net assets acquired). Further, any transaction costs associated with the transaction are expensed as incurred and the costs of debt and equity issuances are recognized in accordance with other applicable accounting requirements.

Purchasing an Asset

FASB Concepts Statement 6[2] states that assets are "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." An asset does not depend on inputs, processes, and outputs but on its own individual value. In the E&P industry, certain types of transactions may be more akin to an asset purchase, including certain mineral interests in a property such as (1) fee ownership or a lease, (2) a concession, or (3) a working interest in unproved properties. Certain direct interests in a property may also be considered an asset purchase (e.g., certain royalty interests, production payments payable in oil or gas, or other nonoperating interests in properties operated by others).

In the E&P industry, certain types of transactions may be more akin to an asset purchase, including certain mineral interests in a property such as (1) fee ownership or a lease, (2) a concession, or (3) a working interest in unproved properties.

The accounting for an asset purchase is more straightforward than that for a business acquisition. For example, goodwill or a gain from a bargain purchase would not be recognized because the asset would be recorded at cost. In addition, rather than expensing transaction costs as incurred (as would be done in a business combination), an entity would generally capitalize transaction costs associated with an asset purchase as part of the initial carrying value of the asset.

Accounting for a Business Acquisition

Once an entity determines that a business acquisition has been consummated, the entity should follow four basic steps in accounting for the business acquisition under ASC 805: (1) identify the acquirer, (2) identify the acquisition date, (3) determine the measurement period, and (4) recognize and measure the acquisition.

Identifying the Acquirer

The acquirer controls the business subject to the transaction (i.e., acquiree). When identifying the acquirer, an entity needs to consider a number of factors, such as whether the acquisition is achieved (1) by transferring cash or other assets or by incurring liabilities or (2) through the exchange of equity interests. In addition, ASC 805 contains a number of considerations that are relevant to this assessment.

Identifying the Acquisition Date

The acquisition date is the date on which the acquirer transfers the consideration due to the acquiree and takes control of the assets and assumes the liabilities of the acquiree. Generally, the acquisition date would be the closing date; however, it may occur **before** the closing date in certain instances.

The effective date of E&P deals usually occurs before the closing date. Therefore, revenue and costs related to the period between the effective date and closing date that are associated with a property acquisition are often accounted for as a purchase price adjustment.

[2] FASB Concepts Statement No. 6, *Elements of Financial Statements* — a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2).

Determining the Measurement Period

The measurement period is the period in which the acquirer completes the business acquisition accounting related to the transaction (e.g., measuring the fair value of the assets acquired and liabilities assumed), which may or may not occur by the end of the current reporting period. During this period, the acquirer will record provisional amounts in its financial statements, updating these amounts in future periods as additional information becomes available. The measurement period cannot exceed one year from the acquisition date.

Recognition and Measurement of Acquisition

Generally, assets acquired, liabilities assumed, and noncontrolling interests, if any, are recognized and measured by the acquirer at fair value. The acquirer then allocates the purchase process on the basis of this fair value assessment. If the consideration provided by the acquirer exceeds the fair value of the net assets exchanged in the transaction, the acquirer records goodwill. Conversely, if the fair value of the net assets exchanged is greater than the consideration provided by the acquirer, a bargain purchase has occurred and the acquirer records a gain on the bargain purchase. Because bargain purchases are expected to be rare, the acquirer must analyze the assets acquired and consideration provided when concluding that a bargain purchase exists. Distressed sales and tax attributes are usually the drivers of a bargain purchase.

Goodwill represents the future economic benefits related to other assets acquired in a business combination, or in an acquisition by a not-for-profit entity, that are not individually identified and separately recognized. Goodwill can arise regardless of whether an entity applies the successful-efforts or full-cost accounting model.

Upon completion of the acquisition, E&P companies need to establish amortization and impairment policies for unproved properties.

When assessing the fair value of the assets, liabilities, and noncontrolling interests in the acquisition, the acquirer should use a valuation technique in which the "highest and best use" is considered from a market participant's perspective. Such techniques include the market approach, income approach, and cost approach. It may be appropriate to use multiple valuation techniques in certain instances.

While there is no prescribed approach for assessing fair value, most E&P companies apply the income approach when valuing the hydrocarbons acquired in the transaction; however, such companies generally use all three of the above approaches to value pipelines and gas plants.

Purchase Price Allocation

Business acquisitions in the E&P industry often include unique assets that may affect purchase price allocation and the resulting accounting.

Proved Versus Unproved Properties

The purchase price allocation will depend on whether the property is considered proved or unproved. When determining the purchase price allocation, E&P companies generally use a couple of common techniques that take into account 3P reserve reports, discount rates, and specific risk factors. Using these techniques, companies will allocate the purchase price to both proved and unproved properties irrespective of whether they use the successful-efforts or full-cost method to account for their reserves.

In addition, upon completion of the acquisition, E&P companies need to establish amortization and impairment policies for unproved properties. In contrast, companies using the full-cost method need to establish a process for transferring unproved properties to the full-cost pool as well as policies for assessing impairment.

It’s too early to speculate on whether the slowing in M&A activity constitutes a trend or a temporary lull. Nevertheless, it is important for E&P companies to understand the nuances of acquisition accounting so that they can effectively and appropriately account for M&A transactions going forward.

Identification of Intangible Assets

The purchase price allocation also depends on any intangible assets[3] that are included in or resulted from the acquisition. In the context of E&P companies, typical intangible assets include acquired contractual rights with favorable terms relative to the market. When valuing intangible assets, the acquirer would generally use the market approach, the income approach, or a combination of both.

Taxes in a Business Combination

Another important consideration related to purchase price allocation is the potential income tax consequences. For instance, the acquirer generally needs to recognize a deferred tax liability or asset for the acquiree’s taxable or deductible temporary differences or operating loss or tax credit carryforwards. One exception would be any differences related to the portion of goodwill for which amortization is not deductible for tax purposes or other similar items. The acquirer will also need to consider the overall deductibility of goodwill.

Final Thoughts

The deal market may have been negatively affected by a number of factors, including concerns about potential changes in the U.S. taxation of O&G activities and rising interest rates that are affecting debt-financed acquisitions. However, other factors may affect M&A activity in a more positive way. For example, oil and natural gas prices have stabilized and are edging upward, making it more desirable and economical to drill for resources. In addition, private equity investors and international buyers continue to express interest in including O&G assets in their portfolios, which may give businesses the incentive to acquire additional assets or grow their investment. The bottom line is that it’s too early to speculate on whether the slowing in M&A activity constitutes a trend or a temporary lull. Nevertheless, as highlighted in this publication, it is important for E&P companies to understand the nuances of acquisition accounting so that they can effectively and appropriately account for M&A transactions going forward.

Deloitte’s O&G practice will continue to monitor standard setting, SEC rulemaking, and other requirements related to M&A activity and, as warranted, will publish additional O&G spotlights and conduct host industry seminars, *Dbriefs* webcasts, and roundtable discussions on this topic.

[3] The Codification Master Glossary defines intangible assets as “[a]ssets (not including financial assets) that lack physical substance. (The term intangible assets is used to refer to intangible assets other than goodwill.)” An intangible asset arises from contractual or other legal rights regardless of whether those rights are transferred or separable from the acquiree or from other rights and obligations.

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