

SAUDI ARABIAN OIL COMPANY (Saudi Aramco)
GENERAL INSTRUCTION MANUAL

GENERAL INSTRUCTION NO.
Approved
216.815

ISSUING ORG. ACCOUNTING POLICIES & SYSTEMS DEPARTMENT
 SUBJECT EXPLORATION COSTS

ISSUE DATE 11-03-07	REPLACES 05-26-03
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CONTENT: This instruction discusses the accumulation, budgeting, reporting, and amortization of costs related to exploration. This instruction incorporates the provisions of Accounting Instruction 502 which has been cancelled and combined with this GI. The text includes:

1. Glossary
2. Definitions of Terms and Phrases
3. General
4. Budgeting for Exploration
5. Accumulating Exploration Costs
6. Exploration and Product/Inventory Costing
7. Abu Sa'fah
8. Responsibilities

1. GLOSSARY

1.1 Acronyms

AP&SD	Accounting Policies & Systems Department
BI	Budget Item
CPF&AD	Capital Programs, Forecast and Analysis Division/FA&PAD
CPU	Capital Projects Unit/PFAAD
D&BI-19U	Drilling & BI-19 Unit /PFAAD
ECC	Exploration Computer Center
FA&PAD	Financial Analysis & Performance Advisory Department
FAD	Financial Accounting Department
FAU	Fixed Assets Unit/PFAAD
GI	General Instruction
GL	General Ledger
NDE	Net Direct Expenditures
P&CAG	Planning & Cost Analysis Group/Exploration Planning & Support Staff
PFAAD	Project & Fixed Assets Accounting Division
SAP	Systems, Applications & Products
WBS	Work Breakdown Structure

1.2 Related Instructions

GI 20.081	Exploration Budget and Program
GI 216.608	Well Accounting and Development Costs
GI 202.330	Capital Assets – Service Lives and Depreciation
AI 125	Abu Sa'fah Production Costing

1.3 Reports

AR-187	Appropriation – Exploratory Drilling and Development Costs
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1.4 General Ledger Accounts

2000102	Development Wells (Crude)
2000105	Pressure Maintenance (Crude)

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2002102	Wells-Oil Gas & Injection
2008002	Intangible Development Costs - (Crude)
2008025	Exploration Costs
2008042	IDC – Gas
2058030	Accumulated Amortization - Exploration
7409851	Exploration Costs Amortization – Current Year
8000904	Reallocated Expense Labor
8000906	Reallocated Expense A&G
8000905	ECC Charges

2. DEFINITIONS OF TERMS AND PHRASES

- | | |
|---|--|
| 2.1. <u>Abu Sa'fah</u> | - An offshore oilfield whose production is shared with the Kingdom of Bahrain. |
| 2.2. <u>Capitalization</u> | - The budgeting, control, and classification of a significant cost as a capital asset. A capital asset is one in which the cost is allocated over the period of its estimated useful life. |
| 2.3. <u>Corporate overhead</u> | - Expenses not directly related to producing, transporting, refining, and selling hydrocarbons. |
| 2.4. <u>Cost of crude oil inventory</u> | - The allocated share of company cost attributed to the inventory rather than that which is sold. |
| 2.5. <u>Cost of producing</u> | - The direct and overhead expenses associated with producing crude oil. |
| 2.6. <u>Directly Attributable Costs</u> | - 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. These represent capitalized costs as defined by IFRS. The company defines these costs by the cost element group in the assessment cycles that allocate costs to capital accounts. |
| 2.7. <u>Expense accounts</u> | - Cost centers usually associated with an organization that include costs for labor, material, invoices, support services, and allocated costs. |
| 2.8. <u>General Ledger</u> | - A report summarizing company financial activity. |
| 2.9. <u>Sub-items (or phases)</u> | - The organization of a WBS account is 33-YYNNN-JJJJ-PPP where the last three numbers are a sub-item or phase number. |

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| 2.10. <u>Sub ledger</u> | - A report of detailed financial information summarized in the general ledger. |
| 2.11. <u>Seismic surveys</u> | - A technique of determining the shape of underground formations through the analysis of sound wave patterns. |
| 2.12. <u>Type Prefix 33 accounts</u> | - WBS accounts for exploration maintained by CPU/PFAAD. |
| 2.13. <u>Type Prefix 63 accounts</u> | - WBS accounts for exploratory water wells maintained by D&BI-19U. |
| 2.14. <u>Type Prefix 75 accounts</u> | - WBS accounts for exploratory wells maintained by D&BI-19U. |
| 2.15. <u>Work Breakdown Structure (WBS)</u> | - A hierarchical organization of a capital project. |

3. **GENERAL**

3.1. **Uses of the Term "EXPLORATION"**

In a general sense within the oil and gas business, "exploration" means the activity of finding new oil and gas fields. However, within Saudi Aramco there are several meanings to the term. Exploration can refer to the Exploration Organization which is comprised of several departments. It may refer to Exploration Organization activities to find new oil fields versus those performed by that organization to develop known oil fields. It can refer to Drilling and Workover Organization activities, which is a separate organization from Exploration, to drill Exploratory Wells. Therefore, the term Exploration may be used in more than one way.

3.2. **WBS Type Prefix 33 VS. Exploratory Wells**

BI 33 is a capital budget term used to plan and control capitalized exploration costs which include both seismic surveys, geophysical/geological studies, staff support (WBS Type Prefix 33) and the drilling of exploratory wells (WBS Type Prefix 75 and 63.) The accounting treatment of capitalized WBS Type Prefix 33 is different from the accounting for exploratory wells. WBS Type Prefix 33 is capitalized as all intangible assets and booked in GL account 2008025, while the cost of exploratory wells is divided into tangible and intangible assets (GI 216.608) and booked either in GL 2000102, 2000105, or 2002102 for tangible assets, and GL 2008002, or 2008042 for intangible assets. All intangible assets are amortized over 15 years. Tangible assets are depreciated over 3 to 25 years (GI 202.330.)

3.3. **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

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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, Saudi 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 returned to 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 amortization of exploration costs was revised from 20 years to 15 years to standardize the amortization policy for all intangible assets.

4. BUDGETING FOR EXPLORATION (BI 33)

Exploration, including costs for seismic surveys, geological/geophysical studies, staff support, and well cost, is a capital program. Exploration costs are budgeted from January 1st through December 31st under BI 33. The final capitalized cost of a well may include costs from two fiscal years. Refer to GI 20.081 "Exploration Budget and Program" for more information about the budgeting process.

5. ACCUMULATING EXPLORATION COSTS

5.1. WBS Accounts

All capital exploration costs go through, and are accumulated in WBS accounts. WBS accounts are sub ledgers for accumulating large capital project costs from the beginning until the end. These accounts have a prefix that indicate a special Type Prefix (broad category of project) and a suffix (phase or sub-item number) that relates to a specific type of cost. Exploration is accumulated in Type Prefix 75 accounts for exploratory well costs and Type Prefix 33 accounts for all other costs (seismic surveys, geological /geophysical studies, and staff support) associated with capitalized exploration.

5.2. Capitalization of Exploratory Wells

Exploratory wells, if successful, are capitalized as complete wells and accounted similar to the accounting of development wells. If the drilling is unsuccessful, the well cost is expensed as Dry Holes and Abandoned Well Expense. Refer to GI216.608 "Well Accounting and Development Costs" for more information on well accounting.

5.3. Type Prefix 33 Exploration Accounts

5.3.1. Exploration Organization Costs.

5.3.1.1. The exploration costs which are accumulated in Type Prefix 33 sub ledger accounts include "Directly Attributable Costs" initially charged to the Exploration Organization, cost center group 1_AEXP1S1 (cost centers 450xxx, 451xxx, 452xxx, 453xxx, 456xxx), and ECC cost centers. ECC is divided into two cost center groups:

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- 1_AECC1S1 (770xxx, 772xxx), 50% of this group's "Directly Attributable Costs" are distributed to Type Prefix 33 accounts (capital) and expense (cost center 778100), the remaining 50% of the "Directly Attributable" cost and all other costs remain in the group cost centers as expense; and
- 1_AECC2S1 (676101, 773xxx), 100% of the group's "Directly Attributable Costs" are distributed to Type Prefix 33 accounts and expensed (cost center 778100). All other costs remain in the group cost centers as expense.

5.3.1.2. IFRS requires that only "Directly Attributable Costs" shall be included in the cost of an asset.

5.3.1.3. Exploration Organization's operating expenses and amortization/depreciation costs not qualified for capitalization are all expensed and allocated to cost center 778100, Petroleum Engineering through SAP/Controlling assessment cycles EXP000 (segment EXP200 and EXP400) and EXP100 (segment EXP400) respectively.

5.3.1.4. The ECC costs not qualified for capitalization remain as expenses in their cost centers.

5.3.1.5. The "Directly Attributable" costs are defined in the assessment cycle EXP000 (segment ECC050 and ECC100 for ECC, EXP100 and EXP300 for Exploration Organization), which are proportionately capitalized (charged to Type Prefix 33 accounts) and expensed (charged to cost center 778100, Petroleum Engineering). The allocation percentile applied to the "Directly Attributable" costs for the Type Prefix 33 accounts and the expense portion (cost center 778100) is determined by the Exploration Organization and submitted to AP&SD in the beginning of each year or whenever there is a change in the levels of operations during the year.

5.3.1.6. The above described reallocations and their related journal entries are done automatically through SAP/Controlling assessment cycles run at month end. Below is the summary of SAP/Controlling assessment cycles and segments applicable to exploration cost with the corresponding below the line cost elements:

<u>Cycle/Segment Elements</u>	<u>Distribution of:</u>	<u>Cost</u>
EXP000/EXP100	Labor & benefits to capital & expense	8000904
EXP000/EXP200	NDE & other cost to expense	8000906
EXP000/EXP400	NDE & other cost to expense	8000906
EXP000/EXP300	Exploration Organization "Directly Attributable Costs" to capital & expense	8000906
EXP100/EXP400	Depreciation to expense	8000906
EXP000/ECC050	50% of ECC "Directly Attributable Cost"	

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to capital & expense

8000905EXP000/ECC100	100% of ECC
"Directly Attributable Cost"	
to capital & expense	8000905

5.3.2. Exploratory Seismic Surveys

Invoiced seismic survey costs, which are not included in the exploration organizational costs as described in section 5.3.1 above, are charged directly to the Type Prefix 33 accounts. A portion of seismic costs (development seismic costs) related to the development of certain fields rather than explorations are charged to Type Prefix 66 development well accounts. These charges are classified as intangible assets and amortized over 15 years.

5.3.3. Capitalization of Cost Accumulated in Type Prefix 33 Accounts

Exploration costs in Type Prefix 33 accounts are automatically capitalized in GL account 2008025 through SAP Asset Management settlement rule in Phase 998 of the Type Prefix 33 WBS accounts. An asset record is created in SAP Asset Management module (Transaction Code AS01) for every WBS account under asset class 38021-00 by CPU. The costs are amortized through depreciation run by crediting GL account 2058030 "Accumulated Amortization Exploration – Current Year" and debiting GL account 7409851 at the rate of 6.67% (15 years amortization) each year. A full year's amortization is taken in the first year of amortization. Amortization will begin automatically for current year exploration, with a start date of January 1 of the current year. A secondary depreciation run after monthly settlement ensures amortization occurs in the same period in which the cost is incurred.

5.3.4. Fully Amortized Costs

In the first month of each year, any fully amortized exploration costs as of the end of the prior year are written off along with the related accumulated amortization.

6. EXPLORATION AND PRODUCT/INVENTORY COSTING

Exploration costs (expensed portion including amortization costs of Type Prefix 33 accounts) are distributed to producing costs and to Master Gas System (MGS) production cost to calculate the inventory and Cost of Sales of crude oil and gas under the Voucher 12 process. Refer to AI 807 for a more complete discussion of the Voucher 12 accounting process.

7. ABU SA'FAH

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 3rd quarter of 2004. Future exploration costs (e.g. capitalized exploration seismic costs) and development seismic costs specific for Abu Sa'fah would require separate WBS and asset records assigned to Abu Sa'fah cost centers to capture their amortized exploration and development seismic costs in the production unit cost calculation of the Abu Sa'fah field. Exploration and ECC costs

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(expensed portion) in general are indirectly shared by Abu Sa'fah field through the allocation process defined in AI 125. Refer to AI 125 for more information.

8. **RESPONSIBILITIES**

The following organizations responsibilities are:

CPU/PFAAD

- Unblock, close, and maintain Type Prefix 33 WBS accounts and all settlement rules.
- Prepare Form SA-630 (Capital Assets Change Authorization) for all fully amortized exploration costs asset records.

D&BI-19U/PFAAD

- Unblock, close, and maintain Type Prefix 75 WBS accounts and all settlement rules.

FAU/PFAAD

- Maintain Asset Class 38021-00.
- Reconcile General Ledger accounts with assets sub ledger accounts
- Process Form SA-630 prepared by CPU to write-off fully amortized exploration costs.

CPF&AD/FA&PAD

- Prepare guidelines for BI 33 budget preparation.
- Monitor BI33 budget versus actual expenditures.
- Create the first level of WBS structure in SAP upon the approval of the Expenditure Request for Exploration Budget (BI 33) for a given year.

FAD

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

P&CAG

- Prepare annual BI 33 budget.
- Prepare annual BI 33 MIS and accountability reports.
- Create and maintain the coding for Type Prefix 33 WBS accounts under BI 33 WBS structure to capture costs of seismic surveys, geophysical/geological studies, and staff support.
- 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 activity of the Exploration Organization to ensure the assessment cycle allocation of their cost centers supports the proportionate activity of the Exploration Organization to exploration in a realistic way.

AP&SD

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- Maintain assessment cycles
- Review annually with Exploration the reasonableness of percentage allocations
- Coordinate Finance reports.
- Add new cost centers and cost center groups.
- Prepare and update accounting policy guidelines.

Approve: Original Approved by FARHAN Al-JABIR**FARHAN W. AL-JABIR, Manager**Accounting Policies & Systems
Department

ABT

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Previous

CEH/CNM W/C #P0312

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