Deloitte.

January 20, 2009
Volume 16, Issue 6

Heads Up

In This Issue:

SEC Modernizes Oil and Gas Company Reporting.

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The SEC recently adopted a final rule amending its oil and gas reporting requirements (the "final rule").[1] SEC Chairman Christopher Cox described the need for and purpose of the revisions, stating:

> In the more than a quarter century since the SEC last reviewed its rules in this area, there have been significant changes in technology that have increasingly limited the usefulness of current disclosures to the market and investors. These updates to the SEC rules will help ensure more meaningful and comprehensive disclosure of information that, even though it does not appear on a company's balance sheet, is of significance to investors in making informed investment decisions.

"[U]pdates to the SEC rules will help ensure more meaningful and comprehensive disclosure of information."

— Christopher Cox

Effective Date and Transition

The final rule is effective for registration statements filed on or after January 1, 2010, and for annual reports on Forms 10-K and 20-F for fiscal years ending on or after December 31, 2009. Early adoption is not permitted in either annual or quarterly reports before the first annual report in which the revised disclosures are required. The SEC staff's view is that accounting changes resulting from the changes in definitions and pricing assumptions should be treated as a change in accounting principle that is inseparable from a change in accounting estimate and applied prospectively.

The SEC staff is discussing the final rule with the FASB and IASB and may delay the effective date. (See "Pricing Used to Estimate Reserves" below for additional information.)

Key Revisions

Many of the revisions are updates to definitions in the rules to make them consistent with the petroleum resource management system (PRMS), which is a widely accepted standard for the management of petroleum resources that was developed by several industry organizations. Key revisions include changes to the pricing used to estimate reserves, the ability to include nontraditional resources in reserves, the use of new technology for determining reserves, and permitting disclosure of probable and possible reserves. See below for additional information on each key revision.

Pricing Used to Estimate Reserves

Existing Requirement	Final Rule Requirement
Companies must use prices on the last day of their fiscal year to determine reserves.	Companies must use a 12-month average price to determine reserves.

[1] Specifically, Rule 4-10 of Regulation S-X and Item 102 of Regulation S-K have been amended, and Industry Guide 2 has been codified into Item 102.

In response to concerns that the use of single-day year-end pricing introduced volatility into the estimation of reserves, the final rule requires a 12-month average price. The average is calculated using the first-day-of-the-month price for each month in the 12-month period before the end of the reporting period. The final rule indicates that the "use of a 12-month average price provides companies with the ability to efficiently prepare useful reserve information without sacrificing the objective of comparability."

As a result of the change to a 12-month average price, different pricing would be used for disclosure and accounting purposes. This is because the reserves (calculated using single-day year-end pricing) are used to determine the depreciation, depletion and amortization, and limitation of capitalized costs included in the full cost pool. The SEC resolved this issue with respect to its rules by:

- Amending the full-cost accounting rules in Regulation S-X[2] to also require the use of 12-month average pricing.
- Eliminating SAB Topic 12.D.3(c),[3] which permitted the consideration of the impact of price increases after the period-end on the ceiling limitation test.

However, both Statements 19[4] and 69[5] prescribe the use of single-day year-end prices for estimating reserves for accounting and disclosure purposes and are beyond the scope of the final rule. The SEC staff is communicating with the FASB and IASB to align their standards that use single-day year-end pricing with the SEC revisions and believes the effective date will provide sufficient time to coordinate such changes. However, in its discussions about the revisions with the FASB and IASB, the SEC will consider whether to delay the effective date.

The "use of a 12-month average price provides companies with the ability to efficiently prepare useful reserve information without sacrificing the objective of comparability."

Editor's Note: Capitalized proved oil and gas property costs are evaluated for impairment under Statement 144.[6] The impairment model in Statement 144 does not use single-day year-end pricing.

Inclusion of Nontraditional Resources in Reserves

Existing Requirement	Final Rule Requirement
Companies are not permitted to include nontraditional resources in reserves.	Companies are required to include nontraditional resources in reserves if they are intended to be upgraded to synthetic oil and gas.

The historical definition of "oil and gas producing activities" excluded sources that involve extraction by means other than "traditional" oil and gas wells (i.e., bitumen and coal and oil shales). However, the final rule indicates that "such sources are increasingly providing energy resources to the world, due in part to advances in technology."

Therefore, the amended definition states that "oil and gas producing activities include the extraction of saleable hydrocarbons, in the solid, liquid, or gaseous state, from oil sands, shale, coalbeds, or other nonrenewable natural resources which are **intended** to be upgraded into synthetic oil or gas, and activities undertaken with a view to such extraction" (emphasis added). Since coal and, to a lesser degree, oil shale are used both as a direct fuel and as a feedstock to be converted into oil and gas, the revised definition will require a company to include coal and oil shale that is **intended** to be converted into oil and gas. However, a company is prohibited from including coal and oil shale that is **not intended** to be converted into oil and gas.

[2] See Regulation S-X, Rule 4-10(c).
[3] SEC Staff Accounting Bulletin Topic 12.D.3(c), "Effect of Subsequent Events on the Computation of the Limitation of Capitalized Costs."
[4] FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies.*
[5] FASB Statement No. 69, *Disclosures About Oil and Gas Producing Activities.*
[6] FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.*

Use of New Technology for Determining and Estimating Reserves

Existing Requirement	Final Rule Requirement
Companies must use specifically prescribed tests to determine and estimate reserves. The use of new technology is not permitted.	Companies may use new technologies to determine and estimate reserves, if those technologies have been demonstrated empirically to lead to reliable conclusions about reserve volumes.

This revision allows reliable technology that did not exist when the rules were originally written to be used to determine and estimate reserves. In addition, the SEC recognized that "technologies . . . will continue to develop, improving the quality of information that can be obtained from existing tests and creating entirely new tests that we cannot yet envision." The revised requirement allows for such technologies to be used in the future. Companies must disclose, in their first filing with the SEC and when they materially add to reserves, the technologies they used to establish reserves.

Disclosure of Probable and Possible Reserves

Existing Requirement	Final Rule Requirement
Companies are required to disclose proved reserves and are **prohibited** from disclosing probable and possible reserves.	Companies are required to disclose proved reserves and are **permitted** to disclose probable and possible reserves.

By "permitting disclosure of all three of these classifications of reserves, our objective is to enable companies to provide investors with more insight into the potential reserves base that managements of companies may use."

The final rule indicates that by "permitting disclosure of all three of these classifications of reserves, our objective is to enable companies to provide investors with more insight into the potential reserves base that managements of companies may use as their basis for decisions to invest in resource development." Disclosures of proved reserves must specify developed and undeveloped reserves by geographic area and final product sold. See the Appendix below for a reprint of a sample tabular disclosure from the final rule.

Incremental Disclosure Requirements

In addition to the revisions to the disclosures described above, the final rule updates Regulation S-K to add the following disclosures:

- "Optional disclosure of oil and gas reserves' sensitivity to price."
- "Disclosure of the development of proved undeveloped reserves" (PUDs), including the total quantity of PUDs at year-end, any material changes to PUDs during the year, investments and progress toward the development of PUDs, and an explanation of the reasons why material concentrations of PUDs have remained undeveloped for five years or more after disclosure as PUDs.
- Disclosure of a "general discussion of the internal controls that [a company] uses to assure objectivity in the reserves estimation process and disclosure of the qualifications of the technical person primarily responsible for preparing the reserves estimates or conducting the reserves audit if the company discloses that such a reserves audit has been performed."

In addition, the final rule (1) clarifies the level of detail required for certain disclosures (which are already required by Industry Guide 2[7]), including the geographic areas by which disclosures of reserves should be made, and (2) provides formats for tabular presentations. The final rule also lists topics that oil and gas companies should consider disclosing in MD&A (e.g., changes to reserves and the reasons for the changes, including changes in prices, information about the performance of currently producing wells, the company's ability to convert undeveloped reserves to developed reserves, and geopolitical risks that apply to material concentrations of reserves).

[7] Industry Guide 2 sets forth the disclosures provided by oil and gas companies regarding their reserves, properties, production, and operations. The rules adopted by the SEC codify the contents of Industry Guide 2 in a new Subpart 1200 of Regulation S-K. Instructions to Items 102, 801, and 802 have been revised to reflect this change. In addition, Instructions 3, 4, and 5 for Item 102, "Description of Property," have been revised to either align them with the new rules or to remove duplication with other Securities Act rules.

Reports of Third Parties

If a company represents that a third party prepared, audited, or performed a process review of the reserves estimates, the company must file a report of the third party as an exhibit to the registration statement or annual report. The full "reserves report" is not required; instead, companies may provide a shorter report that summarizes the work performed by, and the conclusions of, the third party. The report must include specific disclosures required by the Society of Petroleum Evaluation Engineers' audit report guidelines. If the filing is a Securities Act registration statement, the company must file consent of the third party as an exhibit.

Revisions to Form 20-F

Foreign private issuers use Form 20-F to file their annual reports and Exchange Act registration statements. Historically, Form 20-F's "Appendix A to Item 4.D — Oil and Gas" has provided guidance on oil and gas disclosures for foreign private issuers. The SEC has revised Form 20-F to replace Appendix A to Item 4.D with the final rule's provisions on oil and gas disclosures.

Appendix

The final rule contains the following example of a table for providing summary disclosures:

Summary of Oil and Gas Reserves as of Fiscal Year-End Based on Average Fiscal-Year Prices

	Reserves				
Reserves category	Oil (mbbls)	Natural Gas (mmcf)	Synthetic Oil (mbbls)	Synthetic Gas (mmcf)	Product A (measure)
PROVED					
Developed					
Continent A					
Continent B					
Country A					
Country B					
Other Countries in Continent B					
Undeveloped					
Continent A					
Continent B					
Country A					
Country B					
Other Countries in Continent B					
TOTAL PROVED					
PROBABLE					
Developed					
Undeveloped					
POSSIBLE					
Developed					
Undeveloped					

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