

T O U R F R I E N D S A N D C L I E N T S

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## SEC and FASB Update Oil and Gas Interpretations and Standards

On December 31, 2008, the SEC announced significant revisions to the rules governing disclosures by oil and gas companies. These new rules are now effective for all 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. For a more detailed summary of the SEC's new rules, see our To Our Friends and Clients Memorandum, SEC Updates Reporting Requirements for Oil and Gas Companies, available at <http://www.ffhsj.com/index.cfm?pageID=25&itemID=5941>.

Recently new interpretations relating to the SEC's oil and gas disclosure and accounting rules have been released that clarify the new rules and update the SEC's accounting guidance for oil and gas companies. The staff of the SEC's Division of Corporate Finance (the "Staff") released a series of Compliance and Disclosure Interpretations ("C&DIs") in October 2009 that clarify the application and interpretation of several of the new rules and represent the Staff's first interpretations of the new rules. The SEC has separately published Staff Accounting Bulletin No. 113 ("SAB 113"), which updates the Office of Chief Accountant's previous guidance on Topic 12: Oil and Gas Producing Activities, in order to bring existing accounting guidance into conformity with the new rules. In addition, the Financial Accounting Standards Board ("FASB") has released updated accounting standards for oil and gas companies. In January 2010 the FASB released Accounting Standards Update No. 2010-03, Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures ("ASU 2010-03"), aligning U.S. GAAP standards with the SEC's new rules.

Given the technical nature of the SEC's rules, the C&DIs and SAB 113 clarify specific applications of the new rules to oil and gas reserve calculation and reporting. The following memorandum provides a brief summary of a number of the C&DIs and the most significant substantive changes to SAB 113 and ASU 2010-03.

## I. SEC COMPLIANCE & DISCLOSURE INTERPRETATIONS

### a. Disclosure

1. *Third-Party Reserve Estimates:* The SEC's new rules require that a company that uses a third party to prepare oil and gas reserve estimates or to conduct an audit of reserve estimates must then file the third party's report as an exhibit with its SEC filings. Some companies engage third parties to prepare reserve estimates or conduct an audit of a limited portion of the company's reserves. In the C&DIs, the Staff clarifies that a company must also file the third party's report in the case of a limited review. This new interpretation may result in third parties that perform limited reviews implementing more procedures to ensure that they are comfortable with the inclusion of their reports in SEC filings.

2. *Reserve Locations:* The SEC's new rules require a company to disclose reserve estimates by geographic area and for each country containing 15% or more of the company's proved reserves. The Staff notes in the C&DIs that for purposes of identifying the countries in which more than 15% of the company's reserves are located, reserve quantities attributable to equity method investees should be combined with reserve quantities attributable to consolidated entities.

### b. Reserves

1. *Deterministic Estimates:* The C&DIs clarify that in connection with a deterministic reserve evaluation, if a company has determined specific, separate estimates for proved, possible and probable reserves, then it is not appropriate for the company to aggregate these separate reserve categories into one total reserve estimate because the categories have different levels of certainty. The Staff notes that individual estimates for each category should be disclosed as separate estimates and the differences in certainty for each estimate should be fully explained.

2. *Production Sharing Contracts:* The C&DIs indicate that a company may not claim to have proved reserves under a production sharing contract prior to obtaining approval from the relevant host country where such approval is required. Because these contracts are entered into in countries where the governmental authority claims to own the mineral rights in question, a company must obtain all government approvals before claiming proved reserves.

3. *Reserves Above Highest Known Oil Limit:* The C&DIs indicate that for reserves above a Highest Known Oil ("HKO") limit, if it is equally likely that oil or gas is present above the HKO limit, the lower value product should be assigned above HKO only if the well or field is in a location where a market for gas exists. If no market for the gas or no way to transport the gas to the market exists, then a company may not classify as reserves any assumed gas cap volume that may or does exist above HKO.

c. *Probable and Possible Reserves*

1. *Pricing:* For purposes of estimating probable and possible reserves, the Staff clarified that a company should use the same oil and gas price that is used for the evaluation of its proved reserves. The SEC's new rules specified that the methodology for determining the economic producibility of a reservoir should be based on the 12-month average price, calculated as the unweighted average price of the first day of each month within the 12-month period prior to the end of the reporting period.

2. *Assignment of Probable or Possible Reserves:* The C&DIs clarify that, in exceptional cases, companies may assign probable or possible reserves in an area in which it has no proved reserves. The Staff noted several instances in which such an assignment would be acceptable, including in development projects where engineering, geological, marketing, financing and technical tasks have been completed, but where final regulatory approval is lacking or in improved recovery projects (at or near primary depletion) that await production response.

The Staff also clarified that a company may assign probable or possible undeveloped reserves beyond areas containing proved undeveloped reserves using reliable technology. A company may not, however, assign reserves of any kind (including probable or possible reserves) to an un-penetrated, pressure-separated fault block.

3. *Use of the Lowest Known Hydrocarbon Limit:* When determining the amount of probable reserves in a well bore, if the volume of the reserves meets the test for either probable or possible reserves, then it may be acceptable to assign probable or possible reserves below the Lowest Known Hydrocarbon ("LKH") limit. If, however, there is no data available below the LKH, then no reserves should be assigned. The Staff specifically noted in the C&DIs that probable reserves may be assigned if reliable technology and data exist supporting the characterization as probable reserves.<sup>1</sup>

d. *Undeveloped Oil and Gas Reserves*

Under the SEC's new rules, undeveloped reserves are reserves that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for re-completion. The new rules further specify that when calculating undeveloped reserves, a company may only classify undrilled locations as having undeveloped reserves if a development plan has been adopted for drilling in the next five years, absent specific circumstances justifying a longer time period.

The C&DIs clarify a number of factors related to this definition. First, the Staff clarified that for purposes of determining whether the company has adopted a development plan, the mere intent to develop would not alone justify recognition of reserves and that "adoption" requires a final investment decision. Second, the Staff addressed the circumstances under which the five year period could be extended. Although no

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<sup>1</sup> The SEC's new rules already specified that with respect to proved reserves, in the absence of data on fluid contacts, proved quantities of reserves are limited by the LKH unless geoscience, engineering or performance data and reliable technology establish a lower contact with reasonable certainty.

particular type of project justifies a longer time period per se, there are a number of factors that a company should consider, including the following:

- the level of on-going significant development activities in the area to be developed;
- the company's historical record of completing development of comparable long-term projects;
- the amount of time in which the company has maintained the leases, or booked the reserves, without significant development activities;
- the extent to which the company has followed a previously adopted development plan; and
- the extent to which delays in development are caused by external factors related to the physical operating environment rather than by internal factors.

The Staff also noted that a company's decision to slowly develop a field in order to extend the field's economic life does not justify recognizing proved undeveloped reserves beyond five years. A company should not recognize proved undeveloped reserves if it does not expect to initiate development within five years.

*e. Development Projects*

The SEC's new rules include a new definition of "development project," which is defined as the means by which petroleum resources are brought to the status of economically producible. In the C&DI's, the Staff discusses the meaning of this definition noting that it is typically a single engineering activity that has a distinct beginning and end and when complete, will result in the production, processing or transportation of crude oil or natural gas. In addition, the project will have a clear cost estimate, time schedule and investment decision.

*f. Reliable Technology*

The SEC's new rules include a new definition of "reliable technology" that broadens the types of technologies that companies may use to establish reserve estimates and reserve categories and permits a company to use new technologies or a combination of technologies once the reliability can be documented. This expanded definition accounts for the fact that technologies continue to develop and allows companies to utilize changing technologies as they are demonstrated to be reliable. The Staff indicates in the C&DI's that it does not intend to publish a list of reliable technologies that may be used and that each company is responsible for establishing and documenting the technologies that provide reliable results consistent with the new rules. A company may be required to make this information available to the Staff upon request during a review of the company's reserve estimates.

## **II. STAFF ACCOUNTING BULLETIN NO. 113**

The SEC's Office of Chief Accountant also recently issued SAB 113, which conforms the SEC's accounting guidance to the new rules and revises Topic 12: Oil and Gas Producing Activities. The revisions include a number of substantive changes, including:

- for purposes of determining reserves and estimated future net revenues, 12-month average prices should be used rather than year-end prices, and
- when assessing a write-off of excess capitalized costs determined under the full cost method of accounting, the SEC deleted the guidance that allowed a company to apply post-quarter prices since the use of 12-month average prices eliminates the irregularities previously caused by year-end pricing.

## **III. ACCOUNTING STANDARDS UPDATE NO. 2010-03**

The FASB issued Accounting Standards Update No. 2010-03, Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures in order to align U.S. GAAP requirements with the SEC's new disclosure rules. The changes are effective for annual reporting periods ending on or after December 31, 2009 and therefore companies with a December 31 year-end are required to comply with the new standard in their upcoming annual reports.<sup>2</sup> Companies should discuss the new standard with their internal accountants and independent auditors to fully understand the revised standards. The most significant changes include the following:

- expanding the definition of oil and gas producing activities to include the extraction of oil and gas from non-traditional and unconventional sources;
- amending the definition of proved oil and gas reserves to require the use of 12-month average pricing rather than year-end pricing, as well as changing the price used to calculate the aggregate amount of and changes in future cash flows;
- conforming defined terms in the FASB's Master Glossary to the defined terms in Rule 4-10 of Regulation S-X in the SEC's new rules, including conforming the definitions of reliable technology and reasonable certainty;
- requiring separately disclosed information regarding reserve quantities and financial statement amounts for geographic areas representing 15% or more of a company's proved reserves,<sup>3</sup>
- clarifying that a company must consider equity method investments for purposes of determining whether it has significant oil and gas producing activities;

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<sup>2</sup> A company that becomes subject to the standard because of the changes to the definition of significant oil and gas producing activities, however, should apply the standard for periods beginning after December 31, 2009. Early compliance is not permitted. As discussed below, the definition of oil and gas producing activities was expanded to include non-traditional and unconventional sources of extraction and companies that are engaged in these types of extraction will now be subject to the new SEC rules and FASB standards.

<sup>3</sup> Note that ASU 2010-03 requires separate disclosure for areas with "significant reserves." The requirement includes any area with 15% or more of a company's proved reserves, but may also include areas with less than 15% of proved reserves if significant under the standard.

- requiring separate disclosure of the amounts and quantities for consolidated and equity method investments; and
- requiring disclosures regarding equity method investments to have the same level of detail as is required for consolidated investments.

The requirement for expanded disclosures regarding equity method investments is particularly significant and a company must consider its equity method investments for purposes of determining whether it has significant oil and gas producing activities. An exception to the more detailed disclosure requirements exists for investments that were acquired before December 31, 2009 and for which information is not obtainable after making an “exhaustive effort,” however, additional detail will be required for investments made after December 31, 2009. Therefore, companies should ensure that they will be able to obtain the required information going forward prior to completing any pending or future acquisitions.

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