Oil and Gas Year-End Accounting and Auditing Update
Today’s Agenda

• FAS 133 Frequent Problem Areas
• FAS 143 Implementation
• Accounting for Costs Associated with Exit or Disposal Activities—FAS 146
• Accounting for Energy Trading Activities—EITF Issue 02-3
• Special Year-End Reporting Requirements
• Sarbanes-Oxley and Title II Proposed Rules
Today’s Presenters

• Michael Doss
• Herb Listen
• Michael Prendergast
Using Virtual Learning
Virtual Presentation Technology

Message

ID

Presentation
Using the Q&A Feature

• Click Q&A tab

• Click Ask a question to pose question

• Click Review Q&A to see questions & responses
In Order to Receive CPE

If you did not register, or are in a group:

• Ask 1 group member to gather information:
  — Program name, date & viewing location
  — Each participant’s name & UPN

• Group member “signs” email message by stating “I verify individuals listed were present for entire program”

• Send email to: joey.monaco@ey.com
For E&Y employees, what is your level at E&Y?

A. Partner/Principal/Director
B. Senior Manager
C. Manager
D. Senior
E. Staff
For client guests, what is your position at your company?

A. Chief Financial Officer
B. Chief Accounting Officer (or equivalent)
C. Controller (or equivalent)
D. Accounting Manager (or equivalent)
E. Senior Accountant (or equivalent)
FAS 133 Frequent Problem Areas
Frequent Problem Areas

- Issue 1: Application of normal purchases and sales exception:
  - Inflation adjustments – Not OK
  - Commodity purchases in a foreign currency (other than functional currency) – Not OK
  - Natural gas contracts utilizing electricity indices – Not OK
  - Ethanol contracts utilizing gasoline indices – Not OK
  - Unleaded gasoline contracts utilizing crude indices – OK
Frequent Problem Areas (cont’d)

• Issue 2: Terminating cash flow hedges is not an earning event!
  - Balances in OCI must reside there until the cash flows designated as being hedged occur or become probable of not occurring
Frequent Problem Areas (cont’d)

• Issue 3: Not following EITF Topic D-102 to the letter – documentation must be contemporaneous and include:
  – The hedging instrument
  – The hedged item or transaction
  – The nature of the risk being hedged
  – The method to be used retrospectively and prospectively to assess effectiveness
  – The method that will be used to measure ineffectiveness
Frequent Problem Areas (cont’d)

• Issue 4: Post-Enron meltdown of energy trading sector
  – Credit downgrades will affect fair value measurements
  – Certain contracts may no longer qualify for hedge accounting
Terminating (i.e., “cashing out”) a cash flow hedge of future oil and gas sales is accounted for how?

A. Clean out OCI immediately

B. Clean out OCI only if it is a net loss

C. Clean out OCI if sales become probable of not occurring

D. Leave balances in OCI until sales occur

E. Both C & D
FAS 143 Implementation
FAS 143

- Applies to legal obligations arising from the retirement of long-lived assets

- Measure liability at fair value – the amount at which the company would have to pay a third party to assume it

- The liability is discounted and accretion expense (operating item) is recognized over time

- Use of expected cash flow approach effectively mandated – use credit-adjusted risk-free
FAS 143 (cont’d)

• Methodology will be a change in practice for many oil and gas companies because:
  
  – Most do not discount the liability and recognize accretion expense
  
  – Most do not measure the liability at fair value
  
  – Many do not gross up the balance sheet (e.g., the liability is embedded in accumulated DD&A)
  
  – Many assume salvage value of surface equipment will offset reclamation costs
FAS 143 Transition

• Effective for fiscal years beginning after June 15, 2002

• Cumulative-effect approach

• Use current information, current assumptions, and current interest rates

• Pro forma disclosures required
FAS 143 Implementation Issues

• Determining the company's legal obligations

• Issues concerning promissory estoppel

• Distinction between ARO liabilities and environmental remediation liabilities (SOP 96-1)

• Cash flow statement classification of settlements – operating activities (see EITF 02-06)

• Income statement classification of accretion expense
FAS 143 Implementation Issues (cont’d)

• Grouping of assets – amortization field level OK

• Credit-adjusted risk-free rate when the company funds its obligation or has insurance

• Estimating fair value
  
  — If unable to reliably estimate a market risk premium, exclude it per paragraph 62 of CON 7; disclosure required
In your experience, how are oil and gas companies dealing with the “market risk premium” in estimating fair value?

A. Leaving it out (can’t reliably estimate it)
B. Arbitrary assessment (e.g., 5%)
C. Basing it off of actual, similar transactions
D. Using valuation specialists
FAS 143: Full Cost Companies

• Application of Rule 4-01

• Transition: estimating amount of accumulated depletion attributable to dismantlement

• Gain or loss upon settlement of ARO liabilities – take to full cost pool
FAS 143 “Short Cut” Method

ARO expected CF in 10 yrs from 1/1/03 (settle date) 2,500
Recalulation of Accum DD&A:

Discount to 1/1/98 (date incurred) @ 7% (15 yrs) 906
Accrete to 1/1/03 (date of adoption) 1,271
Cumulative accretion through 12/31/02 365
Old accrued ARO balance (included in accum DD&A) 1,100

Remaining reserves 80
Cumulative production 70
Estimated total production 150
"Percent depleted" 46.7%
Capitalized asset retire cost 906

New Accum DD&A @ 1/1/03 423

Transition entry @ 1/1/03:

Accum DD&A - old 1,100
O&G properties 906
ARO liability 1,271
Accum DD&A - new 423
Cumulative effect 312

Quality In Everything We Do
**FAS 143 “Long Haul” Method**

### Actual Historical Reserves

<table>
<thead>
<tr>
<th>Year</th>
<th>Beg</th>
<th>Prod</th>
<th>Adds</th>
<th>Revs</th>
<th>End</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>100</td>
<td>(10)</td>
<td>30</td>
<td>(20)</td>
<td>100</td>
</tr>
<tr>
<td>1999</td>
<td>100</td>
<td>(10)</td>
<td>10</td>
<td>20</td>
<td>120</td>
</tr>
<tr>
<td>2000</td>
<td>120</td>
<td>(10)</td>
<td>20</td>
<td>(30)</td>
<td>100</td>
</tr>
<tr>
<td>2001</td>
<td>100</td>
<td>(20)</td>
<td>10</td>
<td>(20)</td>
<td>70</td>
</tr>
<tr>
<td>2002</td>
<td>70</td>
<td>(20)</td>
<td>20</td>
<td>10</td>
<td>80</td>
</tr>
</tbody>
</table>

### Recalculation of Accum DD&A

<table>
<thead>
<tr>
<th></th>
<th>NBV</th>
<th>Beg</th>
<th>Rate</th>
<th>Prod</th>
<th>DD&amp;A</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>906</td>
<td>100</td>
<td>9.06</td>
<td>10</td>
<td>91</td>
</tr>
<tr>
<td>1999</td>
<td>815</td>
<td>100</td>
<td>8.15</td>
<td>10</td>
<td>82</td>
</tr>
<tr>
<td>2000</td>
<td>734</td>
<td>120</td>
<td>6.12</td>
<td>10</td>
<td>61</td>
</tr>
<tr>
<td>2001</td>
<td>673</td>
<td>100</td>
<td>6.73</td>
<td>20</td>
<td>135</td>
</tr>
<tr>
<td>2002</td>
<td>538</td>
<td>70</td>
<td>7.69</td>
<td>20</td>
<td>154</td>
</tr>
</tbody>
</table>

ARO expected CF in 10 yrs from 1/1/03 (settle date) 2,500

Transition entry @ 1/1/03 (ignores income taxes):

- Discount to 1/1/98 (date incurred) @ 7% (15 yrs) 906
- Accrete to 1/1/03 (date of adoption) 1,271
- Cumulative accretion through 12/31/02 365
- Old accrued ARO balance (included in accum DD&A) 1,100

Accum DD&A - old 1,100
O&G properties 906
ARO liability 1,271
Accum DD&A - new 522
Cumulative effect 213
If a company chooses not to follow the “expected cash flow” approach, which discount rate should it use?

A. Credit-adjusted risk-free rate
B. Rate commensurate with the risk
C. Consult with PPD
D. Both B & C
Accounting for Costs Associated with Exit or Disposal Activities—FAS 146
**FAS 146**

- Applies to:
  - Costs to terminate contractual obligations – for example, operating leases
  - Costs to close/consolidate facilities
  - One-time termination benefits that are not covered by FAS 88 or FAS 112

*The 94-3 Model*
FAS 146 (cont’d)

• Obligations under operating leases – recognized at fair value when the leased property is no longer used

• Termination benefits – likely to be recognized over time, not upfront

• If employee services not required beyond “minimum service period,” recognize liability on communication date
FAS 146 Required Disclosures

- Facts and circumstances leading to the disposal and the expected completion date.

- For each major type of cost associated with the disposal activity: (1) the total amount expected to be incurred, the amount incurred in the period and cumulative to date, and (2) a reconciliation of the beginning and ending liability balances.

- The line item(s) in the income statement in which the costs of disposal are aggregated.
FAS 146 (cont’d)

• Effective for disposal activities initiated after 12/31/02

• Previously recognized disposal liabilities – continue to apply EITF 94-3

• No restatement of previously issued financials
Accounting for Energy Trading Activities—EITF Issue 02-3
Background

• History of Issue 98-10

• Issue added to EITF Agenda in early 2002

• Issues addressed:
  - Gross vs. Net Presentation of Trading Activities
  - Disclosures
  - Valuation Issues
Summary of Issue

• Partial consensus reached at June 2002 meeting:
  - All energy trading activities to be presented on a net basis
  - Certain disclosures required in annual financial statements
  - Working Group formed to address valuation
Summary of Issue (cont’d)

• Consensus reached at October meeting to rescind EITF Issue 98-10
  – Non-derivatives no longer marked to market
  – Fair value accounting model for inventory challenged
  – Disclosures are no longer required

• All FAS 133 trading derivatives required to be reported on a net basis in the income statement

• Valuation and disclosure to be addressed by FASB

• FASB staff observation regarding “day 1” profit
Transition

• Effective for all new contracts executed and inventory purchased after October 25

• Effective on the first day of the first fiscal period beginning after December 15, 2002
  — Contracts and inventory existing on October 25
  — Netting requirements

• Inventory valuation consensus can be applied prospective in certain circumstances

• Special netting transition guidance
Implementation Issues

• Identification of non-derivative contracts

<table>
<thead>
<tr>
<th>Examples:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Storage contracts</td>
</tr>
<tr>
<td>Tolling agreements</td>
</tr>
<tr>
<td>Capacity contracts</td>
</tr>
<tr>
<td>Inventory</td>
</tr>
</tbody>
</table>

• Identification of embedded derivatives

• Identification of new contracts post 10/25/02
**Potential Hedging Strategies**

- **Hedge designation (no retroactive application)**

- **Potential hedging strategies:**

<table>
<thead>
<tr>
<th>Fair Value Hedge of Firm Commitment/Inventory</th>
<th>Cash Flow Hedge of Forecasted Transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Storage, Tolling, Capacity, Transportation agreements</td>
<td>Anticipated purchases and sales around non-derivative contracts</td>
</tr>
<tr>
<td>Inventory</td>
<td>Anticipated sales/purchases of Inventory</td>
</tr>
</tbody>
</table>
Additional Implementation Issues

- Valuation of energy inventory
  - Appropriateness of fair value model
  - ARB 43 challenges
  - Carrying value may not equal “cost”
  - Application of normal purchases and sales
Additional Implementation Issues (cont’d)

• Application of netting consensus:
  – Interplay of June and October netting consensuses
  – “Derivatives held for trading”
  – When are spot energy contracts derivatives?

• Application of normal purchases and normal sales exception

• FR-61 disclosures
Illustrative Example—Inventory

Assumptions—Forward purchase of 1 Bbl of crude for delivery in six months at a fixed price of $30/ Bbl (not normal). Market price of crude oil at time of delivery is $35/ Bbl.

Journal entries in month six before and after delivery:

<table>
<thead>
<tr>
<th>Dr. Derivative Asset</th>
<th>$5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr. Other Income</td>
<td>$5</td>
</tr>
<tr>
<td>Dr. Inventory</td>
<td>$30</td>
</tr>
<tr>
<td>Dr. Inventory adjustment</td>
<td>$5</td>
</tr>
<tr>
<td>Cr. Derivative Asset</td>
<td>$5</td>
</tr>
<tr>
<td>Cr. Accounts Payable</td>
<td>$30</td>
</tr>
</tbody>
</table>
Illustrative Example—Netting

Assumptions—Same assumptions as previous slide except the derivative is held for trading purposes and is immediately sold upon physical delivery at $36/Bbl.

Income Statement Presentation (Life-To-Date):

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>$-</td>
</tr>
<tr>
<td>Other Income/Expense</td>
<td>$5</td>
</tr>
<tr>
<td>Gross Margin</td>
<td>$6</td>
</tr>
</tbody>
</table>
Key Take Aways

• Only contracts that meet the characteristics of a derivative are accounted for at fair value—
  — Notional and underlying, or payment provision
  — Initial net investment
  — Net settlement

• Increased pressure to apply special hedge accounting

• No retroactive hedge designation allowed
Key Take Aways (cont’d)

- Income statement netting required for all derivatives held for trading purposes
- Day 1 Gains/Losses on derivatives must be carefully analyzed and may not be appropriate
- Inventory valuation—look to Category A and B GAAP
To which of the following does the October 2002 netting consensus apply?

A. Energy trading activities
B. All energy-related derivatives
C. Energy-related derivatives held for trading purposes
D. All derivatives held for trading purposes
E. All of the above
Special Year-End Reporting Requirements
Consolidations Interpretation Disclosures

Disclosures required in year-end 2002 financial statements filed after issuance of final Interpretation:

- Determine if it is reasonably possible that at the effective date the company will be required either to consolidate or make disclosures about their involvement with an unconsolidated variable interest entity.

- If so, the company will be required to disclose their involvement with and certain other information about the variable interest entity prior to applying the provisions of the Interpretation.
Guarantees Disclosures (FIN 45)

• FIN 45 disclosure provisions applicable for most guarantees
  • Disclose nature, maximum potential loss, and current carrying amount of liability

• Initial measurement and recognition at fair value

• Effective dates
  • Disclosures—interim or annual periods ending after 12/15/02
  • Initial measurement and recognition—prospectively to guarantees issued after 12/31/02
Disclosure of Critical Accounting Policies

• Rule expected to be codified by year-end is similar to FR-60 and requires in MD&A a discussion of:
  - Basic information needed to understand estimates, such as the underlying methodology and assumptions
  - Effect of estimates on financial presentation
  - Sensitivity of the financial results to changes in the estimates or their underlying assumptions
  - Statement as to whether or not management discussed the development, selection, and disclosure of the estimates with the company’s audit committee
Critical Accounting Policies

- Critical accounting policy:
  - Requires management to make assumptions about matters that are “highly uncertain” at the time the estimate is made, and it must be an estimate for which different estimates reasonably could have been used, or changes are reasonably likely to occur, that would have a material impact on financial results.

- If a choice is made between accounting principles accepted under GAAP, explain the alternatives and why the company made the choice it did.
Critical Accounting Policies (cont’d)

• Examples:
  – Revenue recognition policies and methods
  – Related party transactions
  – Valuation of investments
  – Debt and debt covenants
  – Deferred tax assets
  – Commitments and contingencies
  – Oil and gas reserves
    • Plans to develop PUDs
  – Impairment of oil and gas properties
    • If used, significance of probable/possible reserves
• Still applicable!

• Specific considerations for:
  
  – Off balance sheet arrangements (SPEs)
  
  – Contractual obligations and commercial commitments
  
  – Energy trading activities
  
  – Related party transactions
## Acceleration of Filing Dates

<table>
<thead>
<tr>
<th>Fiscal years ending on or after:</th>
<th>Form 10-Q Deadline</th>
<th>Form 10-K Deadline</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 2002</td>
<td>-</td>
<td>90 days</td>
</tr>
<tr>
<td>December 31, 2003</td>
<td>45 days</td>
<td>75 days</td>
</tr>
<tr>
<td>December 31, 2004</td>
<td>40 days</td>
<td>60 days</td>
</tr>
<tr>
<td>December 31, 2005</td>
<td>35 days</td>
<td>60 days</td>
</tr>
</tbody>
</table>
Sarbanes-Oxley and Title II Proposed Rules
Overview

• Proposed Title II rules issued 12/2/02
  – Scope of Services
  – Partner Rotation
  – Internal Control Reporting

• Comments due 1/13/03

• Final rules due 1/26/03
Services Prohibited Under the Act

1. Bookkeeping or other services related to the accounting records or financial statements
2. Financial information systems design and implementation
3. Appraisal or valuation services
4. Actuarial services
5. Internal audit outsourcing services
6. Management functions or human resources
7. Broker or dealer, investment adviser, or investment banking services
8. Legal services and expert services unrelated to the audit
Management Functions

• No significant change in existing rule

• “Allow GAAS assessment of effectiveness of internal controls and recommendations of improvements in design and implementation”
  — Fundamental to the Audit Process

• “Design and implementation of controls is different from obtaining an understanding of controls”
Expert Services

• Should not act in an advocacy role for client

• Limits ability to provide services to client’s legal counsel in connection with litigation, administrative or regulatory proceedings

• “Where an accountant provides representation before a tax court, the accountant serves as an advocate for his or her client and the accountant's independence would be impaired.”
Partner Rotation

• Section 203 - Partner in charge and independent partner must rotate after 5 years

• SEC proposed rule – exceeds the Act requirements
  – All partners on the engagement team or significant subsidiaries will need to rotate

• 5 year cooling off period

• Transition?
Internal Control Reporting

• AICPA Task Force established, E&Y a member

• Developing a new Auditing Standard
  – Relationship of Section 404 to the audit
  – Guidance on reporting under Sarbanes-Oxley
  – Guidance on communications with audit committees

• Task Force has agreed to follow the audit model for
  “unadjusted audit differences” for uncorrected control
deficiencies
Discuss Client process, timing, impact; Limited opportunities to assist clients

Internal Control Assessment Timing

Client Evaluation Phases (“The Long Journey”):

- Understand the Definition of Internal Control
- Organize a Project Team to Conduct the Evaluation
- Evaluate Internal Control at the Entity Level
- Understand, Document and Evaluate Internal Controls at the Process, Transaction, or Application Level
- Evaluate Overall Effectiveness, Identify Matters for Improvement, and Establish Monitoring Systems
- Report on Internal Control (9/30/03 or 12/31/03)

E&Y Timing:

- Discuss Client process, timing, impact; Limited opportunities to assist clients
- Opportunities to assist with documentation, project management, education, and other services
- E&Y Examination of Management’s Assertion

Sarbanes-Oxley Act Section 404 Documentation

Financial Implications
- 2003 Balance Sheet

Process Implications
- Significant Accounts
- Significant Processes

Inherent and Key Business Risks
- Management Assertions

What Can Go Wrong?
- Controls

Evaluate/ Monitor Report

• Management must take full responsibility for its evaluation of the effectiveness of controls and not rely on our work as a basis for its assessment

Project Management Assistance
- High-level Diagnostic Reviews
- Documentation Assistance
- Education

What Can We Do For Audit Clients?

- Project Management Assistance
- High-level Diagnostic Reviews
- Documentation Assistance
- Education

- Management must take full responsibility for its evaluation of the effectiveness of controls and not rely on our work as a basis for its assessment
Thank You!

Thank you for attending this virtual learning session.