

ENERGY ALERT

RECENT DEVELOPMENTS UNDERSCORE THE NEED TO PROACTIVELY REVIEW AND IMPROVE INTERNAL CONTROLS OVER RESERVES INFORMATION



Recent developments highlight the need for energy industry executives to take proactive steps to address concerns regarding the accuracy of disclosed reserves and the credibility of internal controls and procedures for calculating and disclosing those reserves. In our article [*Restoring Confidence in Reported Oil and Gas Reserves — A Practical Approach*](#), released in May, we outlined a practical five-part plan that upstream companies can implement to ensure the adoption and maintenance of adequate reserve calculation and disclosure procedures. Decisive action in this regard will substantially improve the ability of oil and gas companies and their executives to increase public confidence in their reserves disclosure and minimize related legal issues.

Recent important developments include: (i) Royal Dutch Shell's settlement with U.S. and U.K. securities regulators, (ii) Congressman Dingell's recent correspondence with the Securities and Exchange Commission (SEC) and Financial Accounting Standards Board (FASB), (iii) the SEC's recent public statements regarding its approach to dealing with reserve disclosure issues and (iv) the House Financial Services Committee hearing on reserves-related issues.

Key Focus Points for Energy Industry Executives

A closer look at these developments provides several key focus points for energy industry executives:

- Reserves estimates and disclosure are still very much a priority issue for regulators and lawmakers.
- Internal controls over the preparation and disclosure of reserves information are coming under increased scrutiny.
- Individual executives may be exposed to civil and criminal charges in connection with reserves disclosure.
- There is not yet consensus among lawmakers, regulatory agencies and standard-setting boards as to whether major reforms are necessary to address reserves calculation and disclosure, and, if so, whether such reforms should address internal controls, auditor review and/or guidelines for estimating reserves.

SEC and FSA Cite Failings of Internal Controls, Impose Substantial Penalties in Settlements with Royal Dutch Shell

On July 29, 2004, Shell announced that it had reached agreements in principle with the staff of the SEC and with the United Kingdom's Financial Services Authority (FSA) to resolve the investigations related to Shell's recent series of reserves recategorizations. On August 24, 2004, the SEC issued an Order and the FSA issued a Final Notice, in each case implementing the terms of the respective settlements with Shell. Both the SEC and the FSA concluded that "Shell's overstatement of proved reserves, and its delay in correcting the overstatement, resulted from...the failure of its internal reserves estimation and reporting guidelines to conform to [SEC requirements], and the lack of effective internal controls over the reserves estimation and reporting process."

As part of the agreement with the SEC, Shell has consented, without admitting or denying the SEC's findings or conclusions, to an administrative finding that Shell violated the antifraud, reporting, recordkeeping and internal control provisions of the U.S. federal securities laws and related SEC rules. Shell will pay a \$120 million civil penalty and has undertaken to spend an additional \$5 million to develop and implement a comprehensive internal compliance program.

Under the terms of the settlement with the FSA, Shell has consented, without admitting or denying the FSA's findings or conclusions, to the entry of a Final Notice by the FSA finding that Shell breached market abuse provisions of the United Kingdom's Financial Services and Markets Act 2000 and the Listing Rules made under it. Shell will pay a penalty to the FSA of £17 million.

The SEC and FSA settlements do not prevent the U.S. Department of Justice (DOJ) from filing criminal charges against Shell nor prevent private litigants from pursuing claims against Shell. The settlements with the SEC and the FSA apply only to the Shell group companies, not to individual Shell executives. The SEC, the FSA and the DOJ can still bring civil and/or criminal charges against current or former Shell executives for their role in the reserves restatement matter. In their August 24 announcements, both the SEC and the FSA indicated that their investigations will continue. The SEC stated specifically that the conduct of individual Shell executives will be a focus of the continuing investigation. There also is an ongoing DOJ investigation into the matter.

The fact that Shell has reached settlements with both the SEC and the FSA at the same time and based on virtually the same findings demonstrates the willingness and ability of international regulators to join forces and collaborate in investigating and prosecuting energy companies for reserves matters. According to the SEC, "[t]he degree of international and interagency cooperation in this case has been extraordinary and sets an important precedent for investors that regulatory efforts to police the financial markets will transcend national borders."

The findings of the SEC and the FSA and the terms of the settlements — particularly the \$5 million commitment to an internal compliance program — deliver a clear message about the importance of proactively adopting and maintaining adequate internal controls over reserves estimates and disclosure. Critical steps include conducting a thorough review of existing reserves portfolios and guidelines, ensuring that reserves staff is adequately trained and supervised, providing for robust independent review of reserves estimates and vigilantly monitoring for "red flags," such as restatements of reserves by field partners, conflicting proved reserves bookings for the same field, or changes in economic or commercial assumptions or conditions on which reserves estimates are based.

SEC Staff Urges Companies to Improve Reserves Disclosure

In mid-June, the SEC confirmed that “[w]hile many people have suggested that the SEC change the disclosure requirements for oil and gas companies, the Commission is not currently considering any rule changes that are specific to oil and gas companies nor has the division decided whether to recommend...any such rule changes in the future.” Rather, the SEC is pressing upstream companies to make more robust disclosure voluntarily. The SEC also confirmed that it is carefully reviewing oil and gas company disclosure in light of recent developments, such as the passage of the Sarbanes-Oxley Act in 2002 and the release of the SEC’s MD&A guidance in December 2003.

We expect the SEC to focus its increased scrutiny on how companies calculate and disclose their oil and gas reserves and to heighten its review of related internal controls. Commencing as early as fiscal years ending on or after November 15, 2004, for accelerated filers and July 15, 2005, for all other filers, including foreign issuers, companies will have to include in their filings with the SEC a report containing management’s assessment of the effectiveness of the company’s “internal control over financial reporting,” (including with respect to the preparation of supplemental oil and gas disclosure accompanying the notes to financial statements), as well as an evaluation of any changes in these internal controls effected during the period covered by the report. In complying with the SEC’s recent MD&A guidance, particular attention should be given to describing how reserves are estimated and classified, identifying trends affecting reserves and the business generally, and avoiding boilerplate MD&A that simply updates numbers from period to period.

Congressman Dingell Urges SEC and FASB to Take “Prompt Action” and Implement “Significant Reforms”

On May 4, 2004, Congressman John Dingell (D-MI), ranking Democratic member of the Committee on Energy and Commerce, wrote to the SEC and the FASB announcing an examination by his office (not the full Committee) into recent reserves restatements and requesting related information from both the SEC and the FASB. The SEC and the FASB, on July 1 and June 15, 2004, respectively, issued responses.

In its response, the SEC conceded that, in view of the recent reserves revisions, internal controls at the companies involved may have been inadequate. The SEC explained that public companies are required to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that, among other things, transactions are recorded as necessary (i) to permit preparation of financial statements in conformity with generally accepted accounting principles or other criteria applicable to financial statements and (ii) to maintain accountability for assets. In addition, the SEC noted the requirements of the Sarbanes-Oxley Act of 2002 that, once effective, will require financial officers to certify that they are responsible for establishing, maintaining and regularly evaluating the effectiveness of internal controls over financial reporting, and management to assess and report on the effectiveness of the company’s internal controls over financial reporting.

With respect to the external auditors’ role in reserves controls and disclosure, the SEC noted that auditors are presently responsible for performing limited review procedures related to supplemental oil and gas disclosure and for obtaining an understanding of internal controls. The SEC also stated that auditors will soon be required to attest to and report on management’s assessment of the effectiveness of their internal controls over financial reporting. The SEC indicated that it plans to work with the Public Company Accounting Oversight Board (PCAOB) to consider whether auditors should be required to perform additional work with respect to internal controls over preparation of reserves estimates.

In its response to Congressman Dingell, the FASB indicated that it plans to continue to monitor and evaluate developments and, in consultation with the SEC and the PCAOB, determine whether it should initiate a standard-setting effort relating to reporting of oil and gas reserves. The FASB also noted that it is monitoring the International Accounting Standards Board's project on the extractive industries in order to determine whether there is an opportunity to improve the current accounting and reporting standards for oil and gas companies by converging to an international standard.

Congressman Dingell, in his written response on July 20, 2004, replied that the "time is past for lengthy study" of these issues by the FASB and that he was "underwhelmed, if not outright troubled, by the staff resources and level of review" at the SEC. He called for "significant reforms" and urged "prompt action" by the SEC and the FASB.

House Financial Services Committee Chairman Oxley Cites Internal Control Failures as Source of Reserves Restatement Problems

On July 21, 2004, the House Financial Services Committee convened a hearing to review energy reserves accounting practices and examine whether enhanced disclosure rules and third-party certification proposals could prevent future overestimates of oil and natural gas reserves. In his opening statement, Committee Chairman Michael Oxley asserted that the recent reserves accounting issues raise compelling questions about accounting practices and internal controls at energy companies. Following the hearing, the financial press reported that Chairman Oxley said that the recent reserves restatement problems resulted from poor internal controls rather than poor regulation, and that there is no short-term need to impose new requirements on outside auditors to certify oil reserves.

These recent developments demonstrate the continuing focus on reserves disclosures in the current regulatory environment and underscore the need for executives to act proactively to identify and address reserves-related issues. It is critical for energy industry executives to review and improve their internal controls for the preparation and disclosure of reserves information. While the SEC and other regulatory agencies have historically been somewhat slow to recognize new technologies that energy companies use in making their investment and development decisions, compliance with existing rules and guidelines is more important than ever. Especially in today's environment, failure to act promptly and appropriately may subject individual executives to civil and criminal charges. While the debate continues among lawmakers, regulatory agencies and standard-setting boards about how to respond to the recent reserves restatements and implement reforms to prevent future problems, it is critical that energy company executives stay abreast of related developments and make their views known to regulators and lawmakers.

CONTACT INFORMATION

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