

AU Section 9558A

Required Supplementary Information: Auditing Interpretations of Section 558A

1. Supplementary Oil and Gas Reserve Information

.01 Question—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 932-235, requires publicly traded entities that have significant oil and gas producing activities to include, with complete sets of annual financial statements, disclosures of proved oil and gas reserve quantities, changes in reserve quantities, a standardized measure of discounted future net cash flows relating to reserve quantities, and changes in the standardized measure. In documents filed with the Securities and Exchange Commission (SEC), Regulation S-K requires that the disclosures related to annual periods be presented for each annual period for which an income statement is required and the disclosures as of the end of an annual period be presented as of the date of each audited balance sheet required. These disclosures are considered to be supplementary information and may be presented outside the basic financial statements. In these circumstances, should the auditor consider the provisions of section 558A, *Required Supplementary Information*?

.02 Interpretation—Yes. Also, in addition to the provisions of section 558A, the auditor should also consider the provisions of this interpretation.

.03 Estimating oil and gas reserves is a complex process requiring the knowledge and experience of a reservoir engineer. In general, the quality of the estimate of proved reserves for an individual reservoir depends on the availability, completeness, and accuracy of data needed to develop the estimate and on the experience and judgment of the reservoir engineer. Estimates of proved reserves inevitably change over time as additional data become available and are taken into account. The magnitude of changes in these estimates is often substantial. Because oil and gas reserve estimates are more imprecise than most estimates that are made in preparing financial statements, entities are encouraged to explain the imprecise nature of such reserve estimates.

.04 In applying the procedures specified in section 558A, the auditor's inquiries should be directed to management's understanding of the specific requirements for disclosure of the supplementary oil and gas reserve information, including

- a. the factors considered in determining the reserve quantity information to be reported, such as including in the information (1) quantities of all domestic and foreign proved oil and gas reserves owned by the entity net of interests of others, (2) reserves attributable to consolidated subsidiaries, (3) a proportionate share of reserves of investees that are proportionately consolidated, and (4) reserves relating to royalty interests owned.
- b. the separate disclosure of items such as (1) the entity's share of oil and gas produced from royalty interests for which reserve quantity information is unavailable, (2) reserves subject to long-term agreements with governments or authorities in which the entity participates in the operation or otherwise serves as producer, (3) the entity's proportional interest in reserves of investees

accounted for by the equity method, (4) subsequent events, important economic factors, or significant uncertainties affecting particular components of the reserve quantity information, (5) whether the entity's reserves are located entirely within its home country, and (6) whether certain named governments restrict the disclosure of reserves or require that the reserve estimates include reserves other than proved.

- c. the factors considered in determining the standardized measure of discounted future net cash flows to be reported.

.05 In addition, the auditor should also

- a. inquire about whether the person who estimated the entity's reserve quantity information has appropriate qualifications.¹
- b. compare the entity's recent production with its reserve estimates for properties that have significant production or significant reserve quantities and inquire about disproportionate ratios.
- c. compare the entity's reserve quantity information with the corresponding information used for depletion and amortization, and make inquiries when differences exist.
- d. inquire about the calculation of the standardized measure of discounted future net cash flows. These inquiries might include matters such as whether
 - i. the prices used to develop future cast inflows from estimated production of the proved reserves are based on prices received at the end of the entity's fiscal year, and whether the calculation of future cash inflows appropriately reflects the terms of sales contracts and applicable governmental laws and regulations.
 - ii. the entity's estimate of the nature and timing of future development of the proved reserves and the future rates of production are consistent with available development plans.
 - iii. the entity's estimates of future development and production costs are based on year-end costs and assumed continuation of existing economic conditions.
 - iv. future income tax expenses have been computed using the appropriate year-end statutory tax rates, with consideration of future tax rates already legislated, after giving effect to the tax basis of the properties involved, permanent differences, and tax credits and allowances.
 - v. the future net cash flows have been appropriately discounted.

¹ For example, the Society of Petroleum Engineers has prepared "Standards Pertaining to the Estimating and Auditing of Oil and Gas Reserve Information," which indicate that a reserve estimator would normally be considered to be qualified if he or she (1) has a minimum of three years' practical experience in petroleum engineering or petroleum production geology, with at least one year of such experience being in the estimation and evaluation of reserve information; and (2) either (a) has obtained, from a college or university of recognized stature, a bachelor's or advanced degree in petroleum engineering, geology, or other discipline of engineering or physical science or (b) has received, and is maintaining in good standing, a registered or certified professional engineer's license or a registered or certified professional geologist's license, or the equivalent thereof, from an appropriate governmental authority or professional organization.

- vi. with respect to full cost companies, the estimated future development costs are consistent with the corresponding amounts used for depletion and amortization purposes.
 - vii. with respect to the disclosure of changes in the standardized measure of discounted future net cash flows, the entity has computed and presented the sources of the changes in conformity with the requirements of FASB ASC 932-235.
- e. inquire about whether the methods and bases for estimating the entity's reserve information are documented and whether the information is current.

.06 If the auditor believes that the information may not be presented within the applicable guidelines, section 558A indicates that he ordinarily should make additional inquiries. However, because of the nature of estimates of oil and gas reserve information, the auditor may not be in a position to evaluate the responses to such additional inquiries and, thus, will need to report this limitation on the procedures prescribed by professional standards. The following is an example that illustrates reporting on oil and gas reserve information in that event.

The oil and gas reserve information is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by the Financial Accounting Standards Board. [The auditor should consider including in his report the reason(s) why he was unable to resolve his doubts. For example, the auditor may wish to state that the information was estimated by a person lacking appropriate qualifications.]

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