Chairman Oxley, Ranking Member Frank, and members of the Committee, I want to thank you for this opportunity to present my analysis of the accounting and disclosure issues related to oil and gas reserves.

I am a professor of accounting at the Jesse H. Jones Graduate School of Management, Rice University, Houston, where I have taught since 1982.

Given the time available for my oral testimony, I will present here only the summary of my analysis. My prepared testimony, which has been submitted to the Committee, contains extensive discussion of these issues for the benefit of your Committee members and the public.

Having useful and reliable information on oil and gas reserves is enormously important to the US policy makers, managers of the companies, investors, and the public. Over 150 publicly owned U.S. oil and gas producers file reserves data in their 10-K, and their reported proved total reserves of oil and gas is valued at over $3 trillion.

Companies currently are required to provide unaudited estimates of proved reserves quantities to the Securities and Exchange Commission, using definitions provided by the SEC. In theory, since the SEC’s definitions are strict and conservative, and given rising oil and gas prices and improving recovery techniques, it is hard to envision scenarios where companies could report significant downward revisions in proved reserves. In practice, however, recent large
downward revisions in proved reserves by Shell (20 percent reduction of proved oil and gas reserves) and El Paso (41 percent reduction of proved gas reserves), and smaller restatements by a handful of other companies has shown that the reserves data are indeed vulnerable to disclosure quality risk. In fact, as investors learn more about how reserves are estimated and reported, it might come as surprising to them that items on a company’s balance sheet, such as cash and accounts receivable are subject to far more external audit and internal controls than proved reserves estimates.

Some in the industry argue that only small fixes are needed to improve the usefulness and reliability of reserves data. Others have called for more disclosures. However, the issue for the industry is really the credibility gap that affects the disclosures of reserves data, and resolving it requires potentially new regulations or at least new industry action.

The credibility gap is caused by two related factors, quality credibility and reporting credibility. These two terms correspond to two fundamental characteristics of accounting information – relevance and reliability.

The “quality credibility,” which affects the relevance of the reserves information for investors and other users, is caused by a lack of common technical standards and lack of training and certification programs to propagate the standards among all evaluators. There is also no industry-wide peer review or monitoring program of the work of evaluators.

The “reporting credibility,” which affects the reliability of the reported information, is caused by the fact that reserves disclosure is not audited by external auditors or by external and independent reserves evaluators.

Despite this lack of any auditing requirement or training standards, it is indeed a credit to the hard work and dedication of the industry’s engineers and evaluators that the reserves numbers
they produce are generally stable and are subject to very few downward adjustments.

Nevertheless, rather than relying on continued luck, it is preferable for the SEC and the industry to seriously consider proposals for certification and reserves audit and other proposals. The five proposals presented below, if implemented, would make reserves data more reliable and subject to the same level of auditing standards as other key items on the company’s financial reports.

The first proposal is to require a Certification Program for reserves evaluators. Several industry leaders have called for an industry-wide certification requirement for petroleum reserves evaluators. In addition to technical areas, the certification program would help educate the evaluators about the disclosure regulations of the SEC. Also, ethics education needs be a necessary part of the training. Such a program should be easy to implement given the highly talented work pool that constitutes this respected technical field and the technical nature of the reserves estimation process.

The second proposal to improve the reliability of reserves is to require an independent Reserves Audit. The term reserves audit refers to the use of independent external evaluators to “audit” the “reserves report” prepared for the company. If a reserves audit requirement is to be adopted, the SEC would need to work with the new auditing regulator, PCAOB, and with the petroleum industry to develop technical auditing standards for auditing the reserves reports and consider implementing them.
An immediate benefit of developing and implementing a reserves audit system will be to use them as a basis for SEC’s own internal reserves review process required under the Sarbanes-Oxley Act. A new auditing requirement for reserves report might also provide the SEC and the FASB with the flexibility they need to handle industry demands for relaxing their rule-based procedures to determine reserves and standardized measures.

The third proposal is to require the separation of the reserves auditing function from reserves consulting. As we learned from the recent corporate scandals involving the mixing of auditing and consulting, the SEC should require a strict separation between reserves auditing and reserves consulting functions by a firm for the same client.

Fourthly, the industry and the SEC need to adopt a principles-based approach. The industry and the SEC currently tend to rely on a “rules-based” rather than a “principles-based” approach. Instead, the SEC and the FASB should allow a principles-based implementation of the disclosures requirements, while at the same time imposing strict internal control and external audit requirements to prevent potential abuse of the flexibility.

Finally, the SEC should work toward common international standards for reserves disclosures. The disclosure problems of Shell highlighted the differences in financial reporting standards between the US and several other major economies. Given that the IASB is just starting to work toward reserves disclosure rules, the SEC and the FASB should work with the IASB and international securities regulators to develop consistent disclosure provisions.
Despite the highly technical nature of the reserves estimation process, both preparers and users of the reserves information know that reserves estimation is not an exact science. This make reserves disclosures inherently subject to information quality problems despite trained work done by highly dedicated people. That’s why the reserves data should be disclosed in a way that minimizes the credibility gap that afflicts the current disclosures.

I had mentioned that the current credibility gap is a product of a quality gap and a reporting gap. In my testimony here, I have outlined here five proposals to regulators for closing the credibility gap of the disclosed reserves data. These are (1) to include a certification program to standardize and regulate the “who-what-how-when” of reserves evaluators’ function along with training requirements, (2) to require independent external audit of the reserves disclosures, (3) the separation of reserves evaluation function from the reserves audit function, (4) to move toward a principles-based approach in regulations and accounting standards for reserves disclosures, and (5) to work toward convergence in international standards for reserves estimation and disclosures. These changes, which I support, will lead to a significant improvement in the quality and reliability of reserves data for all users, including the management of energy companies, their investors, and the public.

Thank you for the opportunity to present my views. I will be glad to respond to your questions.