Centre for Financial Market Integrity
CFA INSTITUTE

14 February 2008

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number S7-29-07
Proposed Rule: Concept Release on Possible Revisions to the Disclosure Requirements Relating to Oil and Gas Reserves

Dear Ms. Morris:

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the Concept Release issued by the U.S. Securities and Exchange Commission (SEC or Commission).

The CFA Institute Centre represents the views of investment professionals, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct.*

[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 94,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 130 countries, of whom nearly 82,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 56 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

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Discussion

As stated in the concept release: "oil and gas reserves are among the most significant assets of an oil and gas company." Indeed, for many companies involved in oil and gas extractive activities, their reserves are their *only* significant asset. Market prices for the securities of oil and gas companies are highly sensitive to reserve levels and to expected reserve changes. Current reserves are the basis for forecasts of cash flows, earnings, and distributions to shareholders.[3]

While oil and gas reserves are shown on the balance sheet, the recorded amount bears little or no relationship to the economic value of those reserves for the following reasons:

1. There is little relationship between the amount expended to find oil and gas reserves and the economic value of any reserves discovered. Recording reserves at finding cost is a poor proxy for their economic value.
2. Reserves are reported at amortized cost. Accounting Service Release No. 153 [ASR 153] permits registrants to use either the full cost [FC] method or the successful efforts [SE] method, the primary difference being the treatment of dry hole costs (capitalized under the FC method). Depending on the method chosen, two companies with identical expenditures and reserves will report different carrying amounts.
3. The choice of accounting method affects the application of the "ceiling test" that applies when the carrying cost of reserves must be reduced due to market prices that do not justify the current carrying amount.
4. The choice of accounting method affects reported earnings, as the FC method capitalizes dry hole costs but reports higher amortization. The net effect is that rapidly growing oil and gas companies, which are most likely to require financing, report higher earnings when using the FC method.
5. The choice of accounting method may affect cash from operations [CFO], an important metric for oil and gas companies, as dry hole costs reduce CFO under the SE method but are excluded from CFO under the FC method.[4]

For these reasons, the balance sheet and income amounts reported by oil and gas companies have little utility for financial analysis. The use of two accounting methods means that similar companies may appear very different.

[3] There are many public oil and gas royalty trusts whose shareholder distributions depend directly on the net cash flows from oil and gas production.

[4] In practice, companies using the SE method restore comparability by adjusting their reported CFO and including dry hole costs in capital expenditures.

Fortunately, Statement of Financial Accounting Standards No. 69, *Disclosures about Oil and Gas Producing Activities—an amendment of FASB Statements 19, 25, 33, and 39* (SFAS 69) provides for supplementary disclosures that investors can use to evaluate oil and gas companies, including:

1. Separate disclosure of oil and gas reserves (physical quantities of proved reserves);
2. Separate disclosure by geographic area; and
3. Reconciliation of year-to-year changes in proved reserves, separately showing production, discoveries, purchases and sales, and estimate revisions.

These disclosures allow investors to evaluate each company's exploration effort over time.

SFAS 69 also requires companies to disclose the Standardized Measure of Discounted Future Net Cash Flows Relating to Proved Oil and Gas Reserves, reporting separately,

1. Future cash inflows (based on current price levels)
2. Future production and development costs (also based on current prices)
3. Future income tax expense
4. The discounted present value of the net cash flows using a 10% discount rate
5. Reconciliation of year-to-year changes in the discounted present value, separately showing production, discoveries, purchases and sales, the effect of price changes, and estimate revisions.

Such standardized measures and detailed reconciliations are useful indicators of the value of a company's reserves and the change in those reserves' value over time.[5] The SFAS 69 disclosures can also be used to estimate finding costs on a comparable basis.[6]

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[5] Boone demonstrated that the present value measure of reserve values exhibits significantly more explanatory power than the historical cost measure. [Boone, Jeff P., "Revising the Reportedly Weak Value Relevance of Oil and Gas Asset Present Values: The Roles of Measurement Error, Model Misspecification and Time-Period Idiosyncrasy," *The Accounting Review* (January 2002), pp. 73-106]

[6] For a detailed explanation of how the SFAS 69 disclosures can be used for financial analysis, see Appendix 7B to White, Sondhi, Fried, *The Analysis and Use of Financial Statements, Third Edition* (2003). The appendix can be found at: http://bcs.wiley.com/he-bcs/Books?action=resource&bcsId=1347&itemId=0471375942&resourceId=698 page 21-37

Recommendations

Going forward, our preference would be for a project that would result in a fair value measurement of oil and gas reserves.[7] In the interim, we believe that a limited scope project to improve the information content of the current disclosures would benefit investors at little cost to preparers.

We would support the following changes:

1. Use of a principles-based standard. That is, we believe that disclosures of the estimated quantities of reserves should be based on a company's best estimate using current technology and industry best practices rather than bound by narrow definitions that are the results of prescriptive guidance that has accreted over time. We recognize that the definitions and framework of the Society of Petroleum Engineers' (SPE's) Petroleum Resources Management System (PRMS) could provide expertise and comparability to reserves disclosures sought by accounting standard setters. Adoption of this style of approach would better allow managements to "tell their story" by providing data that is generally accepted as useful within the industry**.**

2. Disclosure of probable reserves should be allowed, but not required, and the disclosures relating to such reserves should be separate from those for proved reserves given the greater uncertainty of probable reserve measures. We would view this as an interim step, to enable preparers and users to become comfortable with these new disclosures.

3. Price assumptions based on overall market conditions rather than the price on a specific date as currently required. The Commission could improve current practice by requiring registrants to use either current market prices (year-end or an average of the past 3 months) or requiring use of futures prices.[8] The Commission should require registrants to disclose the key assumptions made. Companies should not be permitted to use internal undisclosed estimates of future prices.

4. Elimination of the current prohibition on including oil shale, tar sands, and other similar sources in SEC filings. We view such operations as an integral part of oil and gas operations, and current SEC rules result in fragmenting the available information for businesses between SEC filings and other data sources.

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[7] The use of fair value measurements to provide relevant information for investment analysis and decisions is discussed further in the CFA Institute Centre's paper: Comprehensive Business Reporting Model: Financial Reporting for Investors (CBRM). The paper is available at the following link: http://www.cfainstitute.org/centre/cmp/BusinessReportingModel.html

[8] We view the SFAS 69 disclosures as analogous to Level 3 (and in some cases Level 2) measurements under SFAS 157, Fair Value Measurements.

We do *not* support requiring independent audit of the SFAS 69 disclosures. We believe that the current disclosures, which require that estimate revisions be explicitly shown, are sufficient to limit managements from making estimates not supported by data.

Further, we recommend that the SEC and its staff consider the work done by the International Accounting Standards Board regarding its research project on extractive activities. Also, the Canadian Securities Administrators (CSA) recently amended its oil and gas disclosure requirements,[9] which may provide further input for this SEC initiative.

Conclusion

We believe that the Commission should encourage the FASB to undertake a limited scope revision of SFAS 69 to deal with the issues discussed in the concept release within the context of the very useful disclosures required by that standard. Making changes to Commission rules outside of that context would introduce additional cost and complexity both for preparers and users.

We appreciate the opportunity to provide comments to the Commission and its staff regarding the Concept Release. If the Commissioners or their staff have questions or seek further elaboration of our views, please contact Georgene B. Palacky, by phone at 434.951.5326 or by e-mail at georgene.palacky@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht

Kurt N. Schacht, CFA
Managing Director

/s/ Gerald I. White

Gerald I. White, CFA
Chair, Corporate Disclosure Policy Council

cc: Robert Herz, Chair, Financial Accounting Standards Board
Sir David Tweedie, Chair, International Accounting Standards Board
Corporate Disclosure Policy Council

[9] The CSA adopted the Instrument and CP 51-101 in September 2003. NI 51-101 sets out the annual filing requirements for reporting issuers who are involved in oil and gas activities and the general disclosure standards for reporting issuers who are reporting on their oil and gas activities. The disclosure standards apply to any disclosure made by a reporting issuer throughout the year. CP 51-101 includes explanations, discussion, and examples on how the CSA will interpret and apply the Instrument – http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20071012_51-101_not-amend-supp.pdf.