

# **Sarbanes-Oxley Act of 2002 Implications To Oil and Gas Marketing**

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## Introduction and Purpose

***“New disclosure requirements in SEC filings ... and CEO-CFO certification of financial statements add new complexity to information management.”***

Created as a result of the Enron/WorldCom fallout, the Sarbanes-Oxley Act of 2002 (SOX) takes CEO's and CFO's to greater depths of personal responsibility and accountability for the adequacy and effectiveness of internal controls.

New disclosure requirements in SEC filings, such as the internal control review and CEO-CFO certification of financial statements, add new complexity to information management. Internal controls have also become a personal issue for executives and their management teams due to the potential forfeiture of bonus and profits.

The purpose of this document is to provide a perspective on the implications of SOX on internal controls in the marketing of oil and gas production. These implications will be discussed within the context of CEO-CFO responsibility and accountability for ensuring that an effective system of internal controls is in place for compliance. Three valuable outcomes will be used as the platform to examine CEO-CFO responsibility for internal controls in these important functions:

- Price accuracy,
- Process accountability, and
- Transaction transparency.

CEO's and CFO's will benefit from this discussion by taking away a deeper understanding of internal controls that support these outcomes.

## Internal Control Implications

***“The CEO-CFO must evaluate the effectiveness of internal controls ... The Company's 10K and 10Q must include conclusions about internal controls ...”***

SOX requires expanded responsibility for, evaluation of, and disclosure about the Company's internal controls. The impact of four sections should be considered by the CEO-CFO in with regard to their involvement with oil and gas marketing:

- Section 103. Auditing, quality control, and independence standards and rules;
- Section 302. Corporate responsibility for financial reports;
- Section 304. Forfeiture of certain bonuses and profits; and,
- Section 404. Management assessment of internal controls.

*Section 103. Auditing, quality control, and independence standards and rules:* The Public Company Accounting Oversight Board (PCAOB) requires that independent auditors include an evaluation of the Company's internal controls in their report. The evaluation will include a description of material weaknesses in internal controls and material non-compliance with them.

*Section 302. Corporate responsibility for financial reports:* The CEO-CFO must evaluate the effectiveness of internal controls every quarter. The Company's 10-K and 10-Q must include their conclusions about internal controls and explain any significant changes to them. The CEO-CFO must also disclose every fraud, no matter how small, to the Company's auditors and to the Audit Committee of the Company's Board of Directors.

*Section 304. Forfeiture of certain bonuses and profits:* Accounting restatements due to material noncompliance of the Company with reporting requirements of securities laws, and that are the result of misconduct, could result in the CEO-CFO having to reimburse the Company for their bonuses, incentive-based or equity compensation, or for any profits they realize from the sale of Company securities that they own.

*Section 404. Management assessment of internal controls:* New reporting requirements are prescribed for 10-K's. The SEC requires that the 10-K report contain an internal control report, which:

- States management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and,
- Assesses, as of the end of the most recent fiscal year of the Company, the effectiveness of the internal control structure and procedures for financial reporting.

The Company's auditor is required to attest to and report on management's assessment of internal controls. The Securities and Exchange Commission (SEC) has not yet issued a definition of, or framework for, internal controls, but it is expected to closely align with the key internal control concepts of the Committee of Sponsoring Organizations of the Treadway Commission (COSO), [www.coso.org](http://www.coso.org):

- Internal control is a process, a means to an end, and not an end in itself.
- Internal control is not simply policies and forms, but it is affected by people at every level of the organization.
- Internal control should provide reasonable assurance to management and the board, not absolute assurance.
- Internal control is geared to the achievement of business objectives.

John Flaherty, the current COSO chairman, said that this means "... that every division in a company needs to have a documented set of internal rules that control how data is generated, manipulated, recorded and reported ..."

The bottom-line is that the CEO-CFO must gain a deeper appreciation and understanding for internal controls because they now have personal professional responsibility for their effectiveness in managing risk to the company. They now have higher expectations of, and put greater reliance in, management decisions, process workflows, and information systems for ensuring that adequate internal controls are deployed, maintained, adjusted as necessary, and reported on as required.

## CEO and CFO Responsibilities

*“The CEO-CFO must provide an evaluation and assessment of the adequacy and effectiveness of internal controls in the marketing function ...”*

The marketing function of an oil and gas production company is a critical element in the recognition of revenues and division of interests to its partners. It also provides the production and pricing data critical to forecasting revenues, which is a foundational element in developing earnings forecasts for analysts and investors.

The CEO-CFO must provide an evaluation and assessment of the adequacy and effectiveness of internal controls in the marketing function to ensure that risks to company revenues and its partners are effectively managed.

<i>Marketing's Impact</i>			
<i>Income Statement</i>		<i>Balance Sheet</i>	
<i>Sales Revenue</i>	✓	<i>Cash</i>	✓
<i>Cost of Sales</i>		<i>Accounts Receivable</i>	✓
<i>Exploration &amp; Production</i>		<i>Fixed Assets</i>	
<i>Sales &amp; Marketing</i>	✓	<i>Accounts Payable</i>	✓
<i>General &amp; Administrative</i>	✓	<i>Debt &amp; Equity</i>	

How does the marketing organization affect the financial statements of an oil and gas production company? Marketing transactions have a significant impact on the company's Balance Sheet and Income Statement. The direct effect on the Income Statement is seen in revenues and in sales, general and administrative expenses. On the Balance Sheet, marketing transactions directly impact assets in the areas of cash and accounts receivable, and liabilities in the area of accounts payable.

The CEO-CFO does not have direct responsibility for actually managing the marketing function and its internal control environment. However, they do have direct responsibility for ensuring that it is well managed and that objectives and outcomes critical to the company are achieved.

Significant risks to the financial statements from marketing are revenue accuracy, unrecorded liabilities, credit exposure, and forecast accuracy. These risks are directly impacted by three key marketing outcomes: price accuracy, process accountability, and transaction transparency.

## Price Accuracy

The challenge to marketing is to sell and price production in volatile markets while limiting costly variances and imbalances with pipelines and partners. Management of these challenges is necessary in order to reduce the risks to revenue.

*Limiting Nomination Variances:* Setting the nominations for the month and managing them each day requires accurate volume information for each pipeline delivery point. Inaccurate information can result in lower price realizations and pipeline penalties. Accurately measuring this impact is difficult in most organizations, and it can have a significant negative effect on financial results.

*Reducing Pipeline and Partner Imbalances:* Rapidly identifying and resolving imbalances and analyzing the impact of imbalances on the bottom line are challenges for most companies. Imbalances can have a significant effect on the bottom line through the "re-pricing" of production from a period of higher prices to a period of lower prices and through the pipelines system of forced "cash-outs".

### *Unrecorded Liabilities:*

Companies who are responsible for operating wells(operator) are also responsible for balancing partner interests in the operated wells. Whenever a partner takes production in kind there are partner balancing issues that must be valued and recorded on the financial statements of the operating company and of the partner company taking production in kind.

Companies have a responsibility to stakeholders, such as private royalty owners, operating partners and governmental agencies whose production is marketed by the company, to obtain the maximum value for their share. It is common for stakeholders to dispute these royalty payments. As the company cannot easily substantiate marketing best practices, these disputes are costly to both parties and often result in a lengthy verification process and prior period adjustments

## Process Accountability

The process of marketing production, verifying contract compliance, collecting data, and monitoring risk is generally an assortment of "systems" involving manual and disconnected processes. The challenge to marketing in this environment is to manage the risk for human error in analysis and decision-making and eliminate the loss or corruption of essential data.

Spreadsheet applications, such as Excel and Lotus 123, and occasionally database applications, such as Access and Lotus Notes, are used to analyze and report production, pricing, credit analysis, and imbalances. Marketing transaction data is either downloaded from the spreadsheet or database application into the financial system or entered manually. Contract administration is usually manual.

Accounting is impacted by the lack of integration between the financial system and marketing applications. Accountants have to manually reconcile production and pricing data used to accrue monthly revenues to actual data reported by marketing. They also track and reconcile nominations and gas balancing activities outside of the financial system using spreadsheet applications. These typically result in adjustments to revenues, and not necessarily in a timely manner.

“The current state of internal controls within American businesses is surprisingly lax. Most companies have not installed the kind of systems that can track changes to financial data as it moves around internally. ‘You see all these ERP and CRM systems that collect data, but feed into spreadsheets,’ says Erik Guldentops, an executive professor at the management school of the University of Antwerp, Belgium, and an expert on IT controls and auditing. ‘Spreadsheets are a manual process and prone to human error. It doesn’t matter how many usage rules a system has or how complete the documentation is. If data ends in a spreadsheet or any other process where a person works with it’, says Guldentops, ‘the control over the information flow doesn’t exist anymore.’ ... That reliance on human processes won’t cut it with the new Sarbanes-Oxley legislation.” *(Excerpt from the May 15, 2003 issue of CIO Magazine, “Playing By New Rules, Sarbanes-Oxley, Your Risks and Responsibilities”, By Ben Worthen.)*

Automating a vast majority of the marketing process will help to mitigate these risks and transform marketing from a reactive function to a proactive one. A centralized marketing system will provide important features such as automated analysis, access control, and data security, back-up, and retention. Additionally, there is the opportunity to further streamline the process through integration with field services and accounting systems. The results will be improved information integrity and accuracy, as well as reduced opportunity for costly human errors.

### Transaction Transparency

With the SEC imposing more stringent rules regarding executive responsibility, the timeliness of reporting, and deeper levels of disclosure, there is a greater need for increased transparency of marketing transactions. Information that is transparently available to the entire organization for analytics has important benefits. It leads to better decisions, stronger accountability, and improved financial and management reporting.

For example, producers that hedge need to capture the financial transactions and value them against market pricing data to support both management reporting needs and financial reporting for FAS 133. Management is assured of compliance with the company’s pricing strategy, that it is effectively deployed, and that desired results are achieved. If their objectives are not met, then it provides them a basis to make adjustments to the strategy given market conditions. Accounting is provided a basis

for their treatment of the transactions for accounting and financial reporting purposes.

An open approach to the transaction process brings increased assurance and access, thereby providing better alignment with, and accountability of leadership for, achieving company objectives.

## Control Risk Assessment

*“Risk assessment ... enables the CEO-CFO to identify areas where potential weaknesses in internal controls exist ...”*

Management owns the internal control environment. Ensuring compliance with SOX begins with the CEO-CFO, and their management team, assessing where they believe significant risk to the company exists in the marketing function.

Risk assessment speaks directly to SOX section 404, and enables the CEO-CFO to identify areas where potential weaknesses in internal controls exist, and then focus their efforts and resources on strengthening these areas.

### *Price Accuracy*

The objective is to assess the ability of marketing to proactively implement a marketing strategy to realize the maximum price for production and accurately measure the results of their efforts. How would you respond to the following questions?

1. Can you objectively measure the results of your marketing activities?
2. Is your marketing strategy aligned with the overall business strategy?
3. Is your hedging strategy clearly documented and effectively linked to your physical marketing activities?
4. Are your marketing assets (people and technology) integrated within your core operating areas?

If you cannot answer “Yes” to a particular question, then the area is high risk and action needs to be taken to address it. If you answer “Yes”, then what objective evidence exists to validate your answer?

### *Process Accountability*

Increased marketing automation with field operations and accounting will improve information integrity and accuracy and reduce the opportunity for costly human errors. How would you answer the following questions?

1. Do you feel like your marketing group is spending too much time reacting to the day's events and problems rather than focusing on marketing production?
2. Are demands for information from operations and accounting taking up too much of your marketing group's time?
3. Are you forced by time constraints to take the best available pricing option instead of creating a better one?
4. Do you have all the information available as you need it to analyze current activities, create options, and pursue those ideas that improve results?

If you answer "Yes" to questions 1 - 3, or "No" to question 4, then the area is high risk and action needs to be taken to address it. If you answer "No" to questions 1 - 3, or "Yes" to question 4, then what objective evidence exists to validate your answer?

### *Transaction Transparency*

As marketing activities become more transparent they lead to higher standards for accountability. This equates to peace of mind in today's stringent financial reporting climate. How would you respond to the following questions?

1. Are marketing information integrity and transparency consistent with your financial and operating information?
2. Can you quickly assimilate your hedging activities for both financial and management reporting?
3. Can your marketing processes and systems handle the stress of an acquisition or the projected growth your company is expecting?
4. Do your marketing processes support the more stringent Sarbanes-Oxley reporting requirements?

If you cannot answer "Yes" to a particular question, then the area is high risk and action needs to be taken to address it. If you answer "Yes", then what objective evidence exists to validate your answer?

## Conclusion

*“Having effective processes and systems in place that assure compliance with SOX will boost the confidence of company leadership and investors.”*

SOX is a watershed event that has changed how companies think about corporate governance. The bottom line, however, is whether or not management has effective and adequate internal controls in place to govern the creation and documentation of information presented in financial statements.

SOX not only addresses the financial statements but also the underlying processes and systems that produce the information reported in them. Having effective processes and systems in place that assure compliance with SOX will boost the confidence of company leadership and investors. This expands the reach of SOX beyond finance to operations such as oil and gas marketing groups.

The reach of SOX also has the potential to expand beyond public companies. Privately-owned oil and gas production companies that are either anticipating a public offering or a sale to a publicly traded company need to start thinking about compliance with SOX now. Private companies that are potential acquisition targets, or that deal regularly with banks, may need to assess the need to comply even though the law doesn't currently require it.