Statement of Financial Accounting Standards No. 25

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Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies

(an amendment of FASB Statement No. 19)

February 1979

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

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FAS 25 Summary

FASB Statement No. 19, "Financial Accounting and Reporting by Oil and Gas Producing Companies," requires the use of a form of the successful efforts method of accounting and disclosure of reserve quantities, costs incurred, and capitalized costs. The Securities and Exchange Commission (SEC) has incorporated into its rules all the substantive provisions of Statement No. 19 except that the Commission's rules permit, as an acceptable alternative for its reporting purposes, the use of a prescribed form of the full cost method of accounting. In light of this conflict between Statement No. 19 and the SEC's regulations, this Statement:

- Suspends the effective date for applying the requirements of Statement No. 19 related to the successful efforts method of accounting. Oil and gas producing companies not subject to SEC reporting requirements thus are permitted to continue their present methods of accounting.
- Retains, with revision of the effective date, the income tax allocation requirements of Statement No. 19. Those requirements supersede *FASB Statement No. 9,* "Accounting for Income Taxes—Oil and Gas Producing Companies."
- Retains, with revision of the effective date, the requirement of Statement No. 19 to classify production payments payable in cash as debt.
- Retains, with revision of the effective date, the requirements of Statement No. 19 related to disclosure of reserve quantities, costs incurred, and capitalized costs, but permits the required disclosure of reserve quantities to be made outside the financial statements.
- Requires disclosure of the method of accounting for costs incurred in oil and gas producing activities.
- Rescinds the reserve definitions as contained in Statement No. 19 and requires, for financial reporting purposes, the use of the reserve definitions developed by the Department of Energy for its Financial Reporting System and adopted by the SEC for its reporting purposes.

INTRODUCTION AND BACKGROUND INFORMATION

1. *FASB Statement No. 19,* "Financial Accounting and Reporting by Oil and Gas Producing Companies," was issued in December 1977. That Statement was to have become effective for financial statements for fiscal years beginning after December 15, 1978 and for interim periods within those years.

2. By its issuance of *Accounting Series Release (ASR) No. 253,* "Adoption of Requirements for Financial Accounting and Reporting Practices for Oil and Gas Producing Activities," on August 31, 1978, the Securities and Exchange Commission (SEC): (a) adopted the form of successful efforts accounting and the disclosures prescribed by *FASB Statement No. 19;* (b) indicated its intention to develop a form of the full cost accounting method as an alternative acceptable for SEC reporting purposes; (c) concluded that both the full cost and successful efforts methods of accounting, based essentially on historical costs, fail to provide sufficient information on the financial position and operating results of oil and gas producing companies and, accordingly, that steps should be taken to develop an accounting method based on a valuation of proved oil and gas reserves; (d) adopted rules that require financial statement disclosure of certain financial and operating data regardless of the method of accounting followed; and (e) adopted definitions of proved reserves different from those in effect at the time Statement No. 19 was issued. On December 19, 1978, the SEC issued *ASR No. 257,* "Requirements for Financial Accounting and Reporting Practices for Oil and Gas Producing Activities," and *ASR No. 258,* "Oil and Gas Producers—Full Cost Accounting Practices," in which the SEC reaffirmed its conclusions reflected in *ASR No. 253,* adopted definitions of proved reserves developed by the Department of Energy (DOE) for its Financial Reporting System, and prescribed the form of full cost accounting acceptable as an alternative to successful efforts accounting for the SEC's reporting purposes. Those requirements are effective initially for fiscal years ending after December 25, 1978 that are contained in filings that include fiscal years ending after December 25, 1979.

3. After considering the foregoing, the Board has decided to suspend the effective date of *FASB Statement No. 19* for certain provisions related to the basic method of accounting while retaining certain requirements of that Statement related to tax allocation, production payments, and disclosure. Appendix A to this Statement sets forth the basis for the Board's conclusions.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment of FASB Statement No. 19

4. The effective date for application of paragraphs 11-41, 44-47, and 60 of *FASB Statement No. 19* is suspended insofar as those paragraphs pertain to a *required* form of successful efforts accounting. Those paragraphs are not suspended insofar as they provide definitions of terms in paragraph 11 or provide direction and guidance for financial statement disclosures required by paragraphs 57-59. Statement No. 19, including paragraphs 11-47, continues in effect as a Statement issued by the FASB for the purpose of applying paragraph 16 of *APB Opinion No. 20,* "Accounting Changes." [1]

5. If accounting changes are made to adopt the provisions of paragraphs 11-47 of *FASB Statement No. 19,* they shall be made by retroactive restatement as provided in paragraphs 63 and 64 of that Statement. Enterprises that presently follow a form of the full cost accounting method and that subsequently adopt accounting changes to conform to the form of the full cost accounting method specified by the SEC also shall make those changes retroactively by restating the financial statements of prior periods.

6. The disclosure requirements of *FASB Statement No. 19* are amended to permit the disclosures of reserve quantities to be made as supplementary information accompanying but outside the financial statements. The last sentence of paragraph 48 of Statement No. 19 is revised to read as follows: "Those disclosures shall be made within the body of the financial statements, in the notes thereto, or in a separate schedule that is an integral part of the financial statements, except that the disclosures of reserve quantities required by paragraphs 50-56 may be made as supplementary information accompanying but outside the financial statements." The last sentence of paragraph 63 is revised to read as follows: "The disclosures specified by paragraphs 50-59 shall be made when presenting complete sets of financial statements that have been restated pursuant to the provisions of this paragraph."

7. Paragraph 271 of *FASB Statement No. 19,* in which various categories of reserves are defined, is rescinded. For the purpose of applying this Statement and Statement No. 19, the definitions of proved reserves, proved developed reserves, and proved undeveloped reserves shall be the definitions adopted by the SEC for its reporting purposes that are in effect on the date(s) as of which reserve disclosures are to be made.[2] Previously reported quantities shall not be revised retroactively if the SEC definitions are changed.

8. An enterprise engaged in oil and gas producing activities shall disclose in its financial statements the method of accounting for costs incurred in those activities and the manner of

disposing of capitalized costs related to those activities.

9. Paragraph 63 of *FASB Statement No. 19* is amended to change the effective date from "fiscal years beginning after December 15, 1978 and for interim periods within those fiscal years" to "fiscal years ending after December 25, 1979, although earlier application is encouraged." The provision of paragraph 4 of this Statement suspending application of a certain form of the successful efforts method of accounting is an indefinite suspension of that method as a mandatory requirement.

Effective Date

10. This Statement shall be effective for fiscal years beginning after December 15, 1978.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of four members of the Financial Accounting Standards Board. Messrs. March and Mosso dissented.

Mr. Mosso and Mr. March dissent because they think that this action at least partially abdicates the Board's standard-setting responsibility. By suspending *FASB Statement No. 19,* the Board passes an opportunity to significantly narrow the range of accounting alternatives in the oil and gas industry and steps aside while the federal government attempts to resolve the issues. They think the Board should have retained Statement No. 19 as the duly adopted private-sector accounting standard, with an exemption for those companies (registered or nonregistered) electing to use the alternative full cost method permitted under SEC-prescribed rules. Although they disagree with the SEC decision that fails to adopt a standard for uniform use, in their view the Board's failure to narrow the numerous alternatives available to nonregistered companies to at least the two methods that registered companies must follow is not in the public interest. The absence of effective FASB-adopted standards may limit the Board from any significant role in the maintenance of these standards, including the successful efforts method of Statement No. 19. Mr. March and Mr. Mosso also believe more affirmative action would have placed the Board in a better position to maintain an active presence in this critical area of national concern and to reassert leadership in setting accounting standards for the oil and gas industry.

Mr. March also dissents because he believes the last sentence of paragraph 4, which asserts that *FASB Statement No. 19* continues in effect for the purpose of controlling accounting changes under *APB Opinion No. 20,* is not warranted in view of the Board's decision to suspend the effectiveness of that Statement. Since the Securities and Exchange Commission decided to permit two alternative accounting methods for companies subject to its jurisdiction and the Board declined to adopt the approach supported by the dissenting members for all companies, the matter of the justification for accounting changes for both registered and nonregistered companies cannot be guided by the Board.

Members of the Financial Accounting Standards Board:

Appendix A: BASIS FOR CONCLUSIONS

Scope

11. For many years oil and gas producing companies generally have followed various forms of each of two accounting methods, commonly called successful efforts and full cost. In December 1977 the Board issued *FASB Statement No. 19,* "Financial Accounting and Reporting by Oil and Gas Producing Companies," which specified one form of the successful efforts method to be used by all oil and gas producing companies. That Statement was to have become effective for fiscal years beginning after December 15, 1978. The SEC reviewed the Board's decision and decided that, for the present, oil and gas producing companies subject to its reporting requirements should follow either the successful efforts method as provided by Statement No. 19 or a form of the full cost method specified by the SEC in *ASR No. 258.* Reporting to the SEC based on one of those two methods is effective initially for fiscal years ending after December 25, 1978 that are contained in filings that include fiscal years ending after December 25, 1979 as provided by *ASR No. 257.* This Statement addresses conflicts arising because of the differences between Statement No. 19 and the SEC's regulations.

12. The SEC also has concluded that, because it believes neither the full cost nor the successful efforts method provides sufficient information on the financial position and operating results of oil and gas producing companies, an accounting method based on valuations of proved oil and gas reserves should be developed. The proposed method is referred to by the SEC as Reserve Recognition Accounting (RRA). This Statement does not address RRA.

13. The Board issued an Exposure Draft of an amendment of *FASB Statement No. 19* on November 7, 1978 with a 60-day comment period. Letters of comment were received from 27 respondents.

Alternatives Considered

14. The Board considered the following four approaches for resolving conflicts between *FASB*

Statement No. 19's requirements and the SEC's decision to accept the continued use of alternative accounting methods while it considers the development of RRA:

a. Amend Statement No. 19 to suspend its effective date with respect to either the entire Statement or only portions of it.
b. Amend Statement No. 19 so as to permit all oil and gas producing companies (including those not subject to SEC reporting requirements) an election to follow the full cost method prescribed by the SEC for as long as the SEC permits that method to be an acceptable alternative for its reporting purposes.
c. Rescind Statement No. 19.
d. Take no action and let the American Institute of Certified Public Accountants (AICPA) amend or interpret its standards of reporting on financial statements or its rules of professional conduct to resolve the conflicts created by the different standards established by the FASB and the SEC.

15. For the reasons set forth in this Appendix, the Board decided to suspend the effective date for certain provisions of *FASB Statement No. 19.*

Reasons for Suspending the Effective Date for Certain Paragraphs of FASB Statement No. 19

16. The Board considered, during the deliberations that preceded the issuance of *FASB Statement No. 19,* the issue of whether oil and gas producing companies should be permitted to continue to choose between the full cost method and the successful efforts method. The Board rejected the continued use of alternative accounting methods by oil and gas producing companies for the reasons set forth in paragraphs 128-132 of that Statement. Paragraph 129 states:

> The Board has considered the question of accounting alternatives at length, not only in connection with its oil and gas project but also for other projects on its agenda, and has concluded that differences in accounting may be appropriate when significant differences in facts and circumstances exist, but different accounting among companies for the same types of facts and circumstances impedes comparability of financial statements and significantly detracts from their usefulness to financial statement users.

17. In the Board's view, the reasons cited in those paragraphs for not embracing alternatives continue to be valid. While the Board acknowledges the SEC's statutory authority to differ with the Board on substantive matters, such as in connection with the continued use of alternative methods of accounting for oil and gas producing companies subject to SEC reporting requirements while it considers the development of RRA, the Board sees no basis for reversing its earlier decision reached on the basis of extensive due process procedures.

18. The Board's recognition of the form of the full cost method as adopted by the SEC as an

acceptable alternative would provide companies not subject to SEC reporting requirements with the same alternatives granted to companies that are subject to those requirements. Companies not subject to SEC reporting requirements are usually small, and the burden of implementing an accounting change can be particularly heavy for them. The Board was willing to impose that burden when it adopted *FASB Statement No. 19* because of the advantage of comparable reporting by all oil and gas producing companies. Now that two alternative methods are to be permitted for companies subject to SEC reporting requirements and the Commission is considering eventually replacing both of those methods with a completely different method based on RRA, the Board concluded that, at this time, it should not require companies not subject to SEC reporting requirements to adopt either alternative.

19. In addition, the Board's recognition of the form of the full cost method adopted by the SEC as an acceptable alternative would impose on companies not otherwise subject to SEC reporting requirements the regulations, rules, and interpretations of the SEC. The Board believes it is inappropriate for a private sector standard-setting body to impose requirements determined by a governmental agency.

20. Paragraph 4 of this Statement explains that *FASB Statement No. 19,* including paragraphs 11-47, continues in effect as an FASB Statement for the purpose of applying paragraph 16 of *APB Opinion No. 20,* "Accounting Changes." Statement No. 19 "expresses a preference for" the successful efforts method of accounting provided in paragraphs 11-47 and "rejects" other methods of accounting for oil and gas producing activities; accordingly, the Board considers it appropriate to indicate that paragraph 16 of Opinion No. 20 requires that entities proposing to change to an accounting method other than that provided in paragraphs 11-47 of Statement No. 19 bear the burden of justifying that change.

21. The SEC has indicated that, even though its judgment differs from that of the Board in certain respects in this instance, it reaffirms its basic policy of looking to the FASB for the initiative in establishing and improving accounting standards. The SEC has incorporated into its rules the provisions of *FASB Statement No. 19* related to the successful efforts method of accounting, conveyances, income tax allocation, and disclosure. The Board believes that rescinding Statement No. 19 would invalidate its intention to monitor the Statement and provide interpretations of it as they may be needed.

22. The Board considers it essential that it accept responsibility to resolve any problems that arise in implementing its standards. The conflicts between *FASB Statement No. 19* and the SEC's regulations do result in an implementation problem. Therefore, taking no action and letting the AICPA amend or interpret its standards of reporting on financial statements or its rules of professional conduct was not considered to be an acceptable alternative.

23. The Exposure Draft proposed to suspend the applicability of all of the conveyance requirements of paragraphs 42-47 of *FASB Statement No. 19.* It also discussed the possible retention of those conveyance requirements that did not appear to conflict with the form of full

cost accounting then proposed by the SEC, but the limited provisions that might have been retained did not appear to have broad applicability, and it was possible that new conflicts could arise if the SEC's final requirements for full cost accounting differed from the proposed requirements. After considering the requirements for full cost accounting adopted by the SEC in *ASR No. 258,* the Board concluded that it should not suspend the applicability of paragraphs 42 and 43 of Statement No. 19, which address accounting for production payments payable in cash and funds advanced for exploration. The Board believes the conclusion stated in Statement No. 19 that production payments payable in cash and funds advanced for exploration are, in substance, borrowings is consistent with the SEC's final regulations on accounting for those transactions under either the full cost or the successful efforts method of accounting. In other respects, the Board has decided to suspend the applicability of the conveyance requirements in paragraphs 44-47 of Statement No. 19 as proposed in the Exposure Draft because some of those requirements conflict with the full cost method of accounting.

Reasons for Retaining or Revising Certain Provisions of FASB Statement No. 19

24. The SEC has incorporated into its rules the requirements of *FASB Statement No. 19* that pertain to income tax allocation and to disclosures of costs incurred and capitalized costs. The retention of these requirements of Statement No. 19 does not conflict with the SEC's rules.

25. The income tax allocation provisions of *FASB Statement No. 19* superseded *FASB Statement No. 9,* "Accounting for Income Taxes—Oil and Gas Producing Companies," which had permitted different methods of accounting for income tax allocations. The Board believes the income tax allocation provisions of Statement No. 19 to be as appropriate for companies using the full cost method as they are for companies using the successful efforts method.

26. Many observers have advised the Board that information about quantities of oil and gas reserves is essential to understand and interpret the financial statements of oil and gas producing companies and that reserve information is the single most important type of disclosure that could be required. In general, the Board concurs with those views. In the Board's judgment, disclosure of reserve quantities and changes in reserve quantities should be required under any method of accounting.

27. The Board considered suspending the effective date for applicability of the disclosure requirements because they are effectively incremental disclosures only to companies not subject to SEC reporting requirements. However, information about reserves is essential, in the Board's judgment, for assessing the financial position and results of operations of an oil and gas producing company. Some, but not all, users of financial statements of companies not subject to SEC reporting requirements are in a position to obtain reserve information. The Board understood from responses to its Discussion Memorandum, "Financial Accounting and Reporting in the Extractive Industries," and testimony at its public hearing that the principal burden on companies not subject to SEC reporting requirements concerns accounting requirements rather than disclosure requirements. The suspension provision of paragraph 4

permits companies not subject to SEC reporting requirements to continue their present methods of accounting if they so desire.

28. The Exposure Draft proposed the retention of *FASB Statement No. 19's* requirement to disclose information about reserve quantities in the financial statements. Some respondents suggested, however, that those disclosures be made outside the financial statements. Their concerns generally related to the cost, time, or difficulty of obtaining an independent verification of reserve quantity information that may be necessary if disclosure were made in the financial statements. Many companies have *staff* engineers who prepare estimates of proved reserves quantities, but questions have been raised as to whether there are enough *independent* professional engineers to verify those estimates on a timely basis or whether generally accepted engineering standards exist whereby an engineer can verify the work of another. The Board considered those comments in light of several recent developments. The issuance of *FASB Statement of Financial Accounting Concepts No. 1,* "Objectives of Financial Reporting by Business Enterprises," indicates that the Board intends to establish standards for reporting information outside financial statements, and the Board has issued a proposed Statement that would require disclosure *outside* financial statements of information about the effects of changing prices. In addition, as part of the Board's conceptual framework project, progress is being made in the development of distinctions between financial reporting and financial statements. The Board also understands that the petroleum engineering profession is initiating studies to develop uniform guidelines for estimating quantities of proved reserves and to develop standards whereby an independent professional engineer can verify the work of another engineer. Finally, the Board understands that the auditing profession is in the process of developing standards that establish an independent accountant's responsibility to review and verify compliance with a required disclosure permitted to be made outside the financial statements. In view of the evolutionary and experimental nature of deciding where information should be disclosed and the degree of independent verification, the Board believes that, for the present, permitting the required disclosure of reserve quantities to be made outside the financial statements will ensure the provision of this essential information without excessive burden.

29. The Board also reviewed the reasons given in Appendix B of *FASB Statement No. 19* for the requirements to disclose costs incurred and capitalized costs and found them equally valid for a full cost company as for a successful efforts company.

30. Because of the SEC action and the suspension of the effective date for the accounting requirements of *FASB Statement No. 19,* there will not be a single, uniform method of accounting used by all oil and gas producing companies. Therefore, the Board concluded that it is desirable to add a requirement to disclose in the financial statements the method of accounting for costs incurred in oil and gas producing activities and the manner of disposition of capitalized costs relating to those activities. Since the provision of this Statement suspending portions of Statement No. 19 allows companies not reporting to the SEC to apply various forms of successful efforts and full cost accounting, reference to those terms alone may not provide an adequate description of the method followed.

31. Paragraph 7 of this Statement rescinds the definitions of proved reserves, proved developed reserves, and proved undeveloped reserves contained in paragraph 271 of *FASB Statement No. 19* and requires the use of definitions adopted by the SEC for its reporting purposes. As stated in Statement No. 19, the Board believes that conformity of the reserve definitions used in filings with the SEC, in information reported to the DOE for its Financial Reporting System, and in financial statements prepared in conformity with generally accepted accounting principles is desirable. On December 19, 1978, the SEC adopted in *ASR No. 257* the definitions developed by the DOE for its Financial Reporting System. For convenience purposes, the definitions adopted by the SEC and DOE are reprinted in Appendix B to this Statement.

32. *ASR No. 257* provides an exemption from its disclosure requirements if a company's oil and gas operations represent 10 percent or less of total revenue, total earnings, and total assets, as defined. The Board considered whether more specific guidance for applying its general materiality provision should be presented in this Statement. The Board concluded that it would be inappropriate to resolve pervasive materiality issues in the context of this project and that more specific guidance should be provided only after having considered those issues on a comprehensive basis. The provisions of this Statement, as with all the Board's standards, need not be applied to immaterial items.

33. Paragraph 9 of this Statement amends paragraph 63 of *FASB Statement No. 19* to change its effective date to "fiscal years ending after December 25, 1979, although earlier application is encouraged." The SEC's accounting requirements are "effective initially for fiscal years ending after December 25, 1978 that are contained in filings that include fiscal years ending after December 25, 1979, although earlier application is encouraged." The Board believes that it would be unreasonable to impose on companies subject to SEC reporting requirements certain standards related to accounting for oil and gas producing activities, such as Statement No. 19's tax allocation provisions, prior to the time those companies are required to make accounting changes in accordance with the SEC's regulations.

Appendix B: DEFINITIONS OF PROVED RESERVES

34. The following definitions of proved reserves are those developed by the Department of Energy for its Financial Reporting System and adopted by the Securities and Exchange Commission on December 19, 1978 in *ASR No. 257.* Reference should be made to the SEC's reporting requirements for revisions that may have been made since the issuance of *ASR No. 257.*

> *Proved oil and gas reserves.* Proved oil and gas reserves are the estimated quantities of crude oil, natural gas, and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions, i.e., prices and costs as of

the date the estimate is made. Prices include consideration of changes in existing prices provided only by contractual arrangements, but not on escalations based upon future conditions.

1. Reservoirs are considered proved if economic producibility is supported by either actual production or conclusive formation test. The area of a reservoir considered proved includes (a) that portion delineated by drilling and defined by gas-oil and/or oil-water contacts, if any, and (b) the immediately adjoining portions not yet drilled, but which can be reasonably judged as economically productive on the basis of available geological and engineering data. In the absence of information on fluid contacts, the lowest known structural occurrence of hydrocarbons controls the lower proved limit of the reservoir.
2. Reserves which can be produced economically through application of improved recovery techniques (such as fluid injection) are included in the "proved" classification when successful testing by a pilot project, or the operation of an installed program in the reservoir, provides support for the engineering analysis on which the project or program was based.
3. Estimates of proved reserves do not include the following: (a) oil that may become available from known reservoirs but is classified separately as "indicated additional reserves"; (b) crude oil, natural gas, and natural gas liquids, the recovery of which is subject to reasonable doubt because of uncertainty as to geology, reservoir characteristics, or economic factors; (c) crude oil, natural gas, and natural gas liquids, that may occur in undrilled prospects; and (d) crude oil, natural gas, and natural gas liquids, that may be recovered from oil shales, coal, gilsonite and other such sources.

Proved developed oil and gas reserves. Proved developed oil and gas reserves are reserves that can be expected to be recovered through existing wells with existing equipment and operating methods. Additional oil and gas expected to be obtained through the application of fluid injection or other improved recovery techniques for supplementing the natural forces and mechanisms of primary recovery should be included as "proved developed reserves" only after testing by a pilot project or after the operation of an installed program has confirmed through production response that increased recovery will be achieved.

Proved undeveloped reserves. Proved undeveloped oil and gas reserves are reserves that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion. Reserves on undrilled acreage shall be limited to those drilling units offsetting productive units that are reasonably certain of production when drilled. Proved reserves for other undrilled units can be claimed only where it can be demonstrated with certainty that there is continuity of production from the existing productive formation. Under no circumstances should estimates for proved undeveloped reserves be attributable to any acreage for which an application of fluid injection or other improved recovery technique is contemplated, unless such techniques have been proved effective by actual tests in the area and in the same reservoir.

Footnotes

FAS25, Footnote 1--Paragraph 16 of *APB Opinion No. 20* states in part: "The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable.... The issuance of [a Statement of Financial Accounting Standards] that creates a new accounting principle, that expresses a preference for an accounting principle, or that rejects a specific accounting principle is sufficient support for a change in accounting principle. The burden of justifying other changes rests with the entity proposing the change."

FAS25, Footnote 2--The definitions of proved reserves, proved developed reserves, and proved undeveloped reserves adopted by the SEC on December 19, 1978 in *Accounting Series Release No. 257* are presented in Appendix B to this Statement.