

HKN, Inc.
Form 10-K/A
February 03, 2011
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

(Amendment No. 2)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2009

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 1-10262

HKN, INC.

(Exact name of registrant as specified in its charter)

Delaware

95-2841597

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(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer
Identification No.)

180 State Street, Suite 200
Southlake, Texas
(Address of principal executive offices)

76092
(Zip Code)

Registrant's telephone number, including area code **(817)424-2424**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class:
Common Stock, Par Value \$0.01 Per Share

Name of each exchange on which registered:
NYSE AMEX

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No.

Indicate by checkmark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K/A or any amendment to this Form 10-K/A.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "accelerated filer and large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer

Accelerated filer

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Non-accelerated filer

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The aggregate market value of the voting Common Stock, par value \$0.01 per share, held by non affiliates of the Registrant as of June 30, 2009 was approximately \$25 million. For purposes of the determination of the above stated amount only, all directors, executive officers and 5% or more stockholders of the Registrant are presumed to be affiliates.

The number of shares of Common Stock, par value \$0.01 per share, outstanding as of February 1, 2010 was 9,553,847.

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EXPLANATORY NOTE

This Amendment No. 2 on Form 10-K/A is being filed for the purposes of amending the following items of the Annual Report:

- i. **Item 1 (Business)** HKN is revising its disclosures as follows:
 - a. to provide additional information regarding the minimum remaining terms of our leases pursuant to Item 1208(b) of Regulation S-K,
 - b. to disclose the qualifications of the technical person primarily responsible for accepting the final report of the reserves estimates from our third-party engineers,
 - c. to update our proved developed reserves as of December 31, 2008 as well as to include our proved undeveloped oil and gas reserve quantities for the years ended December 31, 2007, 2008, and 2009 and
 - d. to remove any quantitative disclosure of Spitfire's estimated reserves and to disclose the reasons why this information is not included.
- ii. **Item 7 (Management's Discussion and Analysis of Financial Condition and Results of Operations)** HKN is revising its Critical Accounting Estimates and Assumptions to provide additional information regarding our income tax contingency.
- iii. **Item 7A (Quantitative and Qualitative Disclosures about Market Risk)** HKN is revising Item 305 as Not Applicable in accordance with the scaled disclosure requirements available to smaller reporting companies for the year ended December 31, 2009.
- iv. **Item 8 (Financial Statements and Supplementary Data)** HKN is revising footnote 16, Oil and Gas Disclosures, to remove any quantitative disclosure of Spitfire's estimated standardized measure and to disclose the reasons why this information is not included. HKN is also revising footnote 10, Income Taxes, to provide additional information regarding our income tax contingency.
- v. **Item 15 (Exhibits and Financial Statement Schedules)** HKN is providing revised third-party reserve reports in accordance with Item 1202(a)(8) of Regulation S-K.

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HKN previously filed Amendment No. 1 of Form 10-K/A on April 14, 2010 pursuant to Rule 12b-15 of the Securities Exchange Act of 1934, to amend its Annual Report on Form 10-K for the year ended December 31, 2009 by adding the information required by Items 10, 11, 12 and 13 of Part III relating to Directors and Executive Officers of the Registrant, Executive Compensation, Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters, and Certain Relationships and Related Transactions, respectively.

In order to preserve the nature and character of the disclosures as originally filed, except as specifically discussed in this Amendment No. 2 to the Annual Report on Form 10-K/A, no attempt has been made to modify or update such disclosures for events which occurred subsequent to the original filing on February 19, 2010. This Amendment No. 2 to the Annual Report on Form 10-K/A does not otherwise alter the disclosures set forth in the Amendment No. 1 of the Annual Report for the year ended December 31, 2009.

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The following discussion is intended to assist you in understanding our business and the results of our operations. It should be read in conjunction with the Consolidated Financial Statements and the related notes that appear elsewhere in this report. Certain statements made in our discussion may be forward looking. Forward-looking statements involve risks and uncertainties and a number of factors could cause actual results or outcomes to differ materially from our expectations. Unless the context requires otherwise, when we refer to we, us and our, we are describing HKN, Inc. and its consolidated subsidiaries on a consolidated basis.

PART I

ITEM 1. BUSINESS

Overview

Our business strategy is focused on enhancing value for our stockholders through the development of a well-balanced portfolio of energy-based assets. Currently, the majority of the value of our assets is derived from our ownership in Gulf Coast oil and gas properties and in our coalbed methane prospects in Indiana and Ohio. We consider these assets to be strategic for us, and our objective in 2010 is to build the value of these properties by:

- Monitoring and reducing operating costs
- Reducing operational, environmental, financial and third-party dependency risks
- Pursuing possibilities for expanding our footprint in these areas
- Performing economic upgrades and improvements

We are also seeking to identify further investment opportunities in undervalued energy-based assets or companies which could provide future value for our shareholders.

We were incorporated in 1973 in the State of California and reincorporated in 1979 in the State of Delaware. Our corporate offices are located at 180 State Street, Suite 200, Southlake, Texas 76092. Our telephone number is (817) 424-2424, and our web site is accessed at www.hkninc.com. We make available, free of charge, on our website, our Code of Business Conduct and Ethics, Code of Ethics for Senior Financial Officers, Audit Committee Charter and Nominating and Corporate Governance Committee Charter as well as our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports as soon as is reasonably practical after such materials are electronically filed with, or furnished to, the Securities and Exchange Commission (SEC).

Oil and Gas Development and Production Operations

During the three years ended December 31, 2009, we drilled or participated in the drilling of 22 oil and gas wells in North America, completing 20 of the wells drilled. During 2009, we participated in the completion of 2 development wells. As of December 31, 2009, we operate or own a non-operating working interest in 69 oil wells, 65 gas wells and 12 injection wells in the Gulf Coast area of the United States. All of our proved oil and gas reserves are concentrated in the Gulf Coast region of Louisiana and Texas.

Prospect Acreage - In addition to the producing property interests discussed above, we own, through certain wholly-owned subsidiaries, interests in a variety of domestic prospect acreage in the Creole, East Lake Verret and Lapeyrouse fields of Cameron, Assumption and Terrebonne Parishes, respectively, in Louisiana.

See Note 14 Other Information in the Notes to Consolidated Financial Statements contained in Part II, Item 8 of this Annual Report on Form 10-K for financial information about our oil and gas interests.

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During 2009, one domestic customer, Shell, purchased approximately 61% of our consolidated oil and gas sales. During 2008, three domestic customers, Shell, Louis Dreyfus and Sequent, purchased approximately 56% of our consolidated oil and gas sales. During 2007, three domestic customers, Shell, Chevron and Noble, purchased approximately 60% of our consolidated oil and gas sales.

Oil and Natural Gas Marketing

Generally, but not always, the demand for natural gas decreases during the summer months and increases during the winter months. Seasonal anomalies such as mild winters or hot summers sometimes lessen this fluctuation. The spot market for oil and gas is subject to volatility as supply and demand factors fluctuate. We may periodically enter into financial hedging arrangements with a portion of our oil and gas production. In December 2009, we purchased a crude oil commodity floor contract at a premium of \$30 thousand. These activities are intended to support targeted price levels and to manage our exposure to price fluctuations. See Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Oil and Gas Properties and Locations

Production and Revenues See also Note 16 Oil and Gas Disclosures in the Notes to Consolidated Financial Statements contained in Part II, Item 8 of this Annual Report on Form 10-K for certain information about our proved oil and gas reserves. A summary of our ownership in our most significant producing properties at December 31, 2009 is as follows:

	Average Working Interest	Average Revenue Interest
Lake Raccourci	40%	27%
Lapeyrouse	12%	7%
Raymondville	22%	16%
Main Pass Block 35	91%	72%
Creole	15%	11%

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The following table shows, for the periods indicated, operating information attributable to our oil and gas interests:

	2009	2008	2007
Production:			
Natural Gas (Mcf)	388,000	703,000	986,000
Oil (Bbls)	148,000	149,000	172,000
Revenues:			
Natural Gas	\$ 1,542,000	\$ 6,913,000	\$ 7,881,000
Oil	8,643,000	15,293,000	12,538,000
Total	\$ 10,185,000	\$ 22,206,000	\$ 20,419,000
Unit Prices:			
Natural Gas (per Mcf)	\$ 3.97	\$ 9.83	\$ 7.99
Oil (per Bbl)	\$ 58.48	\$ 102.35	\$ 72.95
Production costs per equivalent Mcfe	\$ 6.73	\$ 6.75	\$ 4.29
Amortization per equivalent Mcfe	\$ 2.30	\$ 2.87	\$ 2.72

Acreage and Wells At December 31, 2009, we owned interests in the following oil and gas wells and acreage.

State	Gross Wells		Net Wells		Developed Acreage		Undeveloped Acreage	
	Oil	Gas	Oil	Gas	Gross	Net	Gross	Net
Texas		31		4.53	1,573	304	2,811	237
Louisiana	69	34	44.38	3.93	7,293	2,204	7,453	2,157
Other		12		6.44			1,862	1,210
Total	69	77	44.38	14.90	8,866	2,508	12,126	3,604

Most of our proved undeveloped acreage is subject to lease expiration if initial wells are not drilled within a specified period, generally not exceeding three years. We do not expect to lose any significant lease acreage because of failure to drill due to inadequate capital, equipment or personnel. However, based on our evaluation of prospective economics, we have allowed certain lease acreage to expire and may allow additional acreage to expire in the future.

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Drilling Activity - A well is considered drilled when it is completed. A productive well is completed when permanent equipment is installed for the production of oil or gas. A dry hole is completed when it has been plugged as required and its abandonment is reported to the appropriate government agency. The following tables summarize certain information concerning our drilling activity:

	Exploratory		Number of Gross Wells Drilled Developmental		Total	
	Productive	Drilled	Productive	Drilled	Productive	Drilled
2007	2	3	2	2	4	5
2008	2	2	1	2	3	4
2009	0	0	2	2	2	2
Total	4	5	5	6	9	11

	Exploratory		Number of Net Wells Drilled Developmental		Total	
	Productive	Drilled	Productive	Drilled	Productive	Drilled
2007	0.33	0.44	0.30	0.30	0.63	0.74
2008	0.35	0.35	0.02	0.04	0.37	0.39
2009	0.00	0.00	0.30	0.30	0.30	0.30
Total	0.68	0.79	0.62	0.64	1.30	1.43

Reserve Information - The process of estimating oil and gas reserves is complex and requires significant judgment as discussed in Item 1A, Risk Factors. As a result, we have developed internal policies and controls for reviewing the reserve reports which are prepared by qualified third-party engineers, as defined by the Society of Petroleum Engineers standards. We also require that the independent third-party reservoir engineers ensure that the proved reserve estimates are determined in accordance with SEC definitions and guidance. Our internal policies assign responsibility for review of our third-party reserve reports to our Vice President of Exploration who has more than 20 years of experience in this field.

Our domestic reserve estimates at December 31, 2009, 2008 and 2007 have been prepared by Collarini Associates and Crest Engineering Services, Inc., both of which are independent, registered members of a professional engineering society in the state of Texas. We internally tested these reports to ensure the inputs and assumptions used are reasonable, as well as reviewed the qualifications of both Collarini and Crest. Proved oil and gas reserves are defined as 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. Reservoirs are considered proved if economic productibility is supported by either actual production or conclusive formation tests. The area of a reservoir considered proved includes that portion delineated by drilling and defined by gas-oil and/or oil-water contacts, if any, and 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. Reserves which can be produced economically through application of improved recovery techniques 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.

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The reliability of reserve information is considerably affected by several factors. Reserve information is imprecise due to the inherent uncertainties in, and the limited nature of, the data based upon which the estimating of reserve information is predicated. Moreover, the methods and data used in estimating reserve information are often necessarily indirect or analogical in character rather than direct or deductive. Furthermore, estimating reserve information by applying generally accepted petroleum engineering and evaluation principles involves numerous judgments based upon the engineer's educational background, professional training and professional experience. The extent and significance of the judgments to be made are, in themselves, sufficient to render reserve information inherently imprecise.

After making an exhaustive effort, we were unable to obtain the reserve information necessary from our equity method investment in Spitfire since Spitfire's most recent reserve report data is based on a calendar year end of March 31, 2009. After contacting Spitfire for updated reserve estimates as of December 31, 2009, they indicated these estimates are not available and would not be available to the public. In addition, their reserve report is not compiled in accordance with the SEC guidelines. Therefore, Spitfire has not been included in our estimated reserve quantities of proved oil and gas reserves as of December 2009 and 2008.

	(Unaudited) Total (1)	
	Oil (Barrels)	Gas (Mcf)
	(in thousands)	
Proved reserves:		
As of December 31, 2006	1,856	7,005
Extensions and discoveries	220	311
Revisions	486	(1,135)
Production	(172)	(986)
Purchases of reserves in place		
Sales of reserves in place	(21)	(175)
As of December 31, 2007	2,369	5,020
Extensions and discoveries	371	601
Revisions	(1,132)	(703)
Production	(149)	(703)
Purchases of reserves in place		
Sales of reserves in place		
As of December 31, 2008	1,459	4,215
Extensions and discoveries	221	203
Revisions	82	(1,016)
Production	(148)	(388)
Purchases of reserves in place	1	61
Sales of reserves in place		
As of December 31, 2009	1,615	3,075

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	Oil (Barrels)	Gas (Mcf)
	(in thousands)	
Proved reserves:		
Proved developed reserves at:		
December 31, 2007	1,880	4,619
December 31, 2008	1,417	3,733
December 31, 2009	1,425	2,890
Proved undeveloped reserves at:		
December 31, 2007	489	401
December 31, 2008	42	482
December 31, 2009 (2)	190	185

(1) All reserves were held within the United States for the years ended December 31, 2009, 2008 and 2007.

(2) Our December 31, 2009 proved undeveloped reserves were comprised of 190 thousand barrels of crude oil and 185 thousand Mcf of natural gas, net. Proved undeveloped oil reserves increased 352% from our December 31, 2008 total of 42 thousand barrels of crude oil primarily as a result of the incorporation of 2008 positive drilling results which proved up several additional development locations in our third-party reserve estimates at December 31, 2009. Proved undeveloped natural gas reserves decreased by 62% from December 31, 2008 estimates of 482 thousand Mcf primarily from the removal of undeveloped natural gas reserves at Main Pass 35 due to the uneconomic nature of the projects using 2009 twelve month average gas pricing. During the year ended December 31, 2009, the Company focused its capital program on development drilling and facility improvements and did not incur any capital expenditures or make any significant progress to convert any of our proved undeveloped reserves to proved developed reserves. As of December 31, 2009, no undeveloped reserves that were identified more than 5 years ago remain in our proved reserve portfolio.

At December 31, 2009, we had two fields, Main Pass and Creole Field, that contained 15% or more of our total proved reserves. The following table shows the production for these fields for the year ended December 31:

Field:	2009		2008		2007	
	Oil (Bbls)	Gas (Mcf)	Oil (Bbls)	Gas (Mcf)	Oil (Bbls)	Gas (Mcf)
Main Pass	104,965		100,508		119,815	
Creole Field	23,720	66,342	17,610	22,831	6,848	6,958

Coalbed Methane Prospects - Indiana and Ohio

At December 31, 2009, we currently hold two coalbed methane exploration and development agreements in Indiana and Ohio. The agreements provide for a phased delineation, pilot and development program with corresponding staged expenditures. Third party consultants with a long track record in successful coalbed methane development provide expert advice for these projects. These coalbed methane prospects provide for an area of mutual interest of approximately 400,000 gross acres in Indiana and 400,000 gross acres in Ohio. In association with the Indiana coalbed methane exploration and development agreement, we executed a coalbed methane lease during February 2010 for an area of 84,527 gross acres (54,943 net acres) within the Indiana prospect area. This lease will expire in 2019, if not extended. The Ohio coalbed methane exploration and development agreement expired during 2010, and management is currently considering whether to negotiate an extension of the Ohio agreement. There are no proved reserves or production associated with the Indiana or Ohio coalbed methane prospects. We do not expect to lose any significant acreage associated with our coalbed methane prospects because of failure to develop or drill due to inadequate capital,

equipment, or personnel.

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Currently, we are in the dewatering phase in which the pilot wells are produced to maximize fluid (water) production in order to lower reservoir pressure so that desorption of gas can occur in the pilot test wells on the Indiana Posey Contract area. We continue to evaluate their progress. With the decline in oil and gas commodity prices, resource plays, such as coalbed methane prospects, can become uneconomical in low price environments particularly since all well, facility and flowline costs as well as operating costs during the dewatering/desorption process must be incurred before revenues can be generated. Our discretionary capital expenditures, including costs related to our coalbed methane prospects, may be curtailed at our discretion in the future. Such expenditure curtailments could result in us losing certain prospect acreage or reducing our interest in future development projects.

International Energy Investment Global Energy Development PLC

At December 31, 2009 and 2008, we held an investment in Global Energy Development PLC (Global) through our ownership of approximately 34% of Global s ordinary shares. We account for our ownership of Global shares as a cost method investment. Global is a petroleum exploration and production company focused on Latin America. Global s shares are traded on the AIM, a market operated by the London Stock Exchange. See Note 3 Other Investments in the Notes to Consolidated Financial Statements contained in Part II, Item 8 of this Annual Report on Form 10-K for further information. Additional information regarding Global s operations may be found on their website, www.globalenergydevelopmentplc.com.

Canadian Energy Investment Spitfire Energy, Ltd.

At December 31, 2009 and 2008, we held an investment in Spitfire Energy, Ltd. (Spitfire) through the ownership of approximately 25% and 27%, respectively, of Spitfire s currently outstanding common shares. Spitfire is an independent public company (TSX-V; SEL) engaged in the exploration, development and production of crude oil, natural gas and natural gas liquids in Western Canada. At December 31, 2009, we owned 9.9 million common shares of Spitfire and 1.3 million warrants to acquire common shares of Spitfire. As a result of our ownership of Spitfire s outstanding common shares, we are deemed to have the ability to exert significant influence over Spitfire s operating and financial policies. Accordingly, we reflect our investment in Spitfire as an equity method investment. During 2009, we sold approximately 1.2 million shares of Spitfire in the market for total proceeds of \$212 thousand. Additional information regarding Spitfire s operations may be found on their website, www.spitfireenergy.com.

Investment in BriteWater International, LLC (formerly UniPureEnergy)

In June 2009, we acquired a 19.5% interest in a private company, BriteWater International, LLC (BWI), formerly known as UniPureEnergy Acquisition, LLC (UniPure Energy), which holds patents to the emulsion breaking OHSOL technology. This environmentally-clean process can be used to purify oilfield emulsions by breaking and separating the emulsions into oil, water and solids. This technology has been successfully tested using a mobile OHSOL unit in a demonstration in Prudhoe Bay, Alaska, which demonstrated the effectiveness of the OHSOL emulsion breaking technology to recover valuable hydrocarbons and reduce wastes. BWI is currently pursuing opportunities to commercialize the OHSOL technology by performing emulsion testing of the OHSOL plant equipment both internationally and domestically.

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Discontinued Operations – Canergy Management Company and Canergy Growth Fund

In 2008, we created the Canergy Growth Fund to invest in the Canadian junior oil and gas market. As a result of the dramatic decline in the U.S. and foreign stock markets, and in order to avoid future additional significant losses, Canergy Growth Fund divested of all of its common stock holdings in Canadian junior oil and gas companies during 2008. With the continued economic volatility in 2009, we did not participate in any additional investments during 2009. In the fourth quarter 2009, we chose to dissolve the Canergy Growth Fund and Canergy Management Company. The results of operations have been reclassified to discontinued operations in our Consolidated Financial Statements. See Note 13 Discontinued Operations in the Notes to Consolidated Financial Statements contained in Part III, Item 8 of this Annual Report on Form 10-K for further information.

Energy-Based Trading Investments

In 2008, due to the dramatic volatility in the U.S. and international stock markets, we terminated all our common stock and common stock derivative contracts used for trading purposes. We had previously maintained an investment portfolio of investments in energy industry and foreign currency securities traded on domestic securities exchanges. We did not participate in the trading of energy-based investments in 2009. Therefore, we had no total potential obligations or exposure associated with such instruments as of December 31, 2009. See Note 3 Other Investments in the Notes to Consolidated Financial Statements contained in Part II, Item 8 of this Annual Report on Form 10-K for financial information regarding our trading activities.

Employees

At December 31, 2009, we had 16 employees. We have experienced no work stoppages or strikes as a result of labor disputes and consider relations with our employees to be satisfactory. We maintain group medical, dental, surgical and hospital insurance plans for our employees.

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PART II

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion is intended to assist you in understanding our business and the results of our operations. It should be read in conjunction with the Consolidated Financial Statements and the related notes that appear elsewhere in this report. Certain statements made in our discussion may be forward looking. Forward-looking statements involve risks and uncertainties and a number of factors could cause actual results or outcomes to differ materially from our expectations. See Cautionary Statements at the beginning of this report on Form 10-K for additional discussion of some of these risks and uncertainties. Unless the context requires otherwise, when we refer to we, us and our, we are describing HKN, Inc. and its consolidated subsidiaries on a consolidated basis.

BUSINESS OVERVIEW

Our business strategy is focused on enhancing value for our stockholders through the development of a well-balanced portfolio of energy-based assets. Currently, the majority of the value of our assets is derived from our ownership in Gulf Coast oil and gas properties and in our coalbed methane prospects in Indiana and Ohio. We consider these assets to be strategic for us, and our objective in 2010 is to build the value of these properties by:

- Monitoring and reducing operating costs
- Reducing operational, environmental, financial and third-party dependency risks
- Pursuing possibilities for expanding our footprint in these areas
- Performing economic upgrades and improvements

2009 Recap and 2010 Outlook

During 2009, commodity pricing for both crude oil and natural gas averaged well below pricing from the respective prior year period. In 2009, industry-wide drilling costs did not reduce in comparison to the dramatic drop in commodity prices. In order to allow our operations to continue to generate cash flow from operating activities, we focused on reducing our costs by cutting our operating expenses by 20% and our general and administrative costs by 39% over prior year. However, oil and gas commodity prices during the year averaged approximately 43% and 60% lower, respectively, than 2008. In 2010, our objective is to continue to maintain and/or improve our working capital and to increase our operating margin as compared to prior year. We believe in the long-term fundamentals of our industry.

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In 2009, we used our discretionary cash to simplify our capital structure by redeeming the remaining 44 thousand shares of our Series M Preferred Stock and six hundred shares of our G1 Preferred Stock for a total of approximately \$4.4 million. The Series M Preferred had an 8% cash coupon rate which was scheduled to increase to 10% in October 2009. As of December 31, 2009, our Series M Preferred is no longer outstanding. In accordance with our share buyback program, in 2009, we also repurchased 708 thousand of our common shares in the market (approximately 7% of our outstanding shares) at a total cost of approximately \$1.9 million.

During 2009, we enhanced the value of our Main Pass 35 field, located offshore Louisiana in the Gulf of Mexico, by performing various process and structural upgrades and improvements to the facility and its equipment. We believe our Main Pass 35 asset has unique characteristics such as low-decline oil production, behind-pipe development potential as well as third-party oil, gas and water processing and handling services for neighboring fields in the area. We consider our Main Pass 35 field a strategic asset for us in 2010.

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During 2009, we acquired an interest in a private company, BriteWater International, LLC (BWI), formerly known as UniPureEnergy Acquisition, LLC, which holds patents to the emulsion breaking OHSOL technology. This environmentally-clean process can be used to purify oilfield emulsions by breaking and separating the emulsions into oil, water and solids. This technology has been successfully tested using a mobile OHSOL unit in a demonstration in Prudhoe Bay, Alaska, which demonstrated the effectiveness of the OHSOL emulsion breaking technology to recover valuable hydrocarbons and reduce wastes. We are currently pursuing opportunities to commercialize the OHSOL technology by performing emulsion testing of the OHSOL plant equipment both internationally and domestically. We are deemed the primary beneficiary of BWI, and as a result, effective June 30, 2009 (the investment date) we began consolidating the assets and liabilities and results of operations of BWI as of the investment date.

We are also seeking to identify further investment opportunities in undervalued energy-based assets or companies which could provide future value for our shareholders.

Each year we evaluate our assets to determine which may have reached their full potential, do not have an expectation of near-term value enhancement or represent a disproportionate concentration of value in one asset and should be targeted for monetization. In 2010, we are targeting certain of our non-strategic Gulf Coast oil and gas properties for divestiture in order to mitigate possible future losses of these end-of-life properties.

We continue to have access to capital, and we have a cash balance of approximately \$7 million at December 31, 2009. We also anticipate our operating cash flow and other capital resources, if needed, will adequately fund our planned capital expenditures and other capital uses over the near-term. Based on industry outlook for 2010, prices for oil and natural gas are expected to increase as compared to the prior year. In addition, with savings expected due to cost-cutting measures already implemented, we have budgeted our 2010 operations to remain cash-flow positive.

Capital Deployment Update

During 2009, we continued our efforts to deploy assets into energy-based opportunities to build annual measurable value and/or cash flow as follows:

- We deployed capital expenditures of approximately \$831 thousand to enhance the value of our Main Pass 35 field through process, structural, environmental and operational improvements to the facility.
- We deployed capital expenditures of approximately \$1.3 million for oil and gas exploratory and development drilling at our Creole Field, as well as other projects.
- In accordance with our share buyback program, in 2009, we repurchased 708 thousand of our common shares in the market (approximately 7% of our outstanding shares) for total proceeds of approximately \$1.9 million.

- We simplified our capital structure by redeeming 44 thousand shares of our Series M Preferred Stock and six hundred shares of our G1 Preferred Stock for a total of approximately \$4.4 million. As of December 31, 2009, our Series M Preferred Stock is no longer outstanding.

Gulf Coast Oil and Gas Properties

During 2009, our results of operations reflect decreased oil and natural gas revenues as compared to 2008 as a result of decreased commodity prices. During the current year, the realized price of oil averaged \$58.48 per barrel (Bbl), approximately 43% lower than 2008. Natural gas prices realized in 2009 averaged

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\$3.97 per metric cubic foot (Mcf), approximately 60% lower than prior year. Substantially all of our production is concentrated in twelve oil and gas fields along the onshore and offshore Texas and Louisiana Gulf Coast. As of December 31, 2009, our net domestic production rate was averaging approximately 519 barrels of oil equivalent (boe) per day.

Our revenues are primarily derived from sales from our oil and gas properties. Approximately 54% of our production comes from our operated properties all located in the United States. These revenues are a function of the oil and gas volumes produced and the prevailing commodity price at the time of production, and certain quality and transportation discounts. The commodity prices for crude oil and natural gas as well as the timing of production volumes have a significant impact on our operating income. During 2009, our oil and gas revenues were comprised of approximately 85% oil sales and 15% natural gas production.

The following field data updates the status of our operations through December 31, 2009:

Main Pass, Plaquemines Parish - Louisiana

During 2009, we enhanced the value of our Main Pass 35 field, located offshore Louisiana in the Gulf of Mexico, by performing various process and structural upgrades and improvements to the facility and its equipment. We believe our Main Pass 35 asset has unique characteristics such as low-decline oil production, behind-pipe development potential as well as third-party oil, gas and water processing and handling services for neighboring fields in the area. We consider our Main Pass 35 field a strategic asset for us in 2010.

We have an average 91% interest in Main Pass 35 and are the field operator. This field contains a ten-platform facility complex including separation, injection, compression, processing and transportation terminals for oil, water and gas. The field also contains 66 wellbores (60 oil and 6 injection wells), of which 33 are active, and an eight mile oil transport line with pump/metering facilities. Our Main Pass 35 facility is located approximately six miles offshore in state waters off the Gulf Coast of Louisiana. We currently have license to 21 square miles of 3D seismic data covering the area held by productive leases. Gross production during 2009 averaged approximately 400 boe per day. In order to lower our gas lift expense in the field, we are currently planning a recompletion project of at least one gas zone soon after some required modifications to the gas sales line that services the field are completed.

Creole Field, Terrebonne Parish - Louisiana

We hold an average 15% non-operated working interest in this offshore field. Gross daily production from the wells (nine completions) was approximately 952 boe per day during 2009. Three completions in two wells drilled in late 2008 were put on production in 2009 after significant weather delays. In mid-2009, we participated with one of the other working interest owners in a revised third party reserve study. The study was based in large part on a new geologic interpretation which incorporated the latest drilling results and a significantly improved speculative 3D seismic volume. As a result of this study, three new proved undeveloped locations, six new probable locations and twenty new possible locations have been identified and documented. Two re-entries, one major workover and one new well are anticipated in 2010.

Lapeyrouse Field, Terrebonne Parish - Louisiana

We hold an average non-operated working interest of approximately 12% in the production from nine wells in this field. Gross field production averaged approximately 198 boe per day for 2009. Evaluation efforts by the operator are still ongoing with additional diagnostic work planned by the operator to address the field pressure decline and to utilize all available wellbores. We are considering this field for divestiture in 2010, although no final decision has been made at this time.

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Lake Raccourci Field, Lafourche Parish Louisiana

We hold an average 40% operated working interest in each of our Lake Raccourci wells. Gross production for this field averaged 78 boe per day for 2009. Production decreased significantly this quarterly period primarily due to the fact that the SL 14284-1 well ceased production in February 2009. Diagnostic work indicated that the well ceased production due to sand build up in the tubing. Coiled tubing work was carried out, but failed to restore production. We are currently evaluating the economic potential of a recompletion to the Tex 16 zone behind pipe, as well as several other zones in our two other producing wells in the field. We are considering this field for divestiture in 2010, although no final decision has been made at this time.

Point-a-la-Hache Field, Plaquemines Parish Louisiana

We maintain a 25% operated working interest in one producing well in this field. Average gross production for 2009 was approximately 40 boe per day. Production remains steady from this one well field.

East Lake Verret, Assumption Parish Louisiana

We have an average 5% non-operated working interest in this field. Gross daily production from the two development wells on this project was approximately 699 boe per day during 2009.

Point-au-Fer Field, Terrebonne Parish Louisiana

We own a 12.5% non-operated working interest in this approximate 56 square mile area. Gross production for this field was approximately 33 boe per day for 2009. Several prospects have been identified in the area, but due to the low oil and gas pricing, we expect additional drilling and work over activity will be delayed by the operator.

Branville Bay Field, St. Bernard Parish Louisiana

We own a 12.5% non-operated working interest in two state leases in the Branville Bay area of Chandeleur Sound Block 71. Gross production for this field was approximately 221 boe per day for 2009.

BP 2D Texas Gulf Coast Project, Various Counties - Texas

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We own a 25% non-operated working interest in the Boquillas #1 well. Gross production from this well is steady and was approximately 170 boe per day for 2009.

NW Speaks Field, Lavaca County Texas

We own approximately 2% to 7% in various leases in the NW Speaks area. Current gross production for this field averaged approximately 92 boe per day during 2009 from two wells.

Allen Ranch Field, Colorado County Texas

We own an 11.25% non-operated working interest in this area. Gross production for this field was approximately 57 boe per day during 2009 primarily from the initial well, the Hancock Gas Unit #1 which is the only well currently producing from the field. Another development location has been identified, but future development of the field is currently on hold pending higher natural gas pricing.

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Raymondville Field, Willacy County Texas

We own an average 22% non-operated working interest in this area. Current gross production for this field averaged approximately 336 boe per day during 2009. Field production continues to decline as fewer behind pipe zones remain. Several wells ceased production in 2009 and have no remaining recompletion potential. We are considering this field for divestiture in 2010, although no final decision has been made at this time.

Lucky Field, Matagorda County - Texas

We own a 7.5% non-operated working interest in this area. Current gross production for this field averaged approximately 46 boe per day during 2009.

Coalbed Methane Prospects Indiana and Ohio

We hold two exploration and development agreements in Indiana and Ohio which provide for an area of mutual interest of approximately 400,000 acres each respectively. The agreements provide for a phased delineation, pilot and development program, with corresponding staged expenditures. Contracted third parties with a long track record in successful Coalbed Methane development provide expert advice for these projects.

On the Indiana Posey Prospect, we completed Phase I Core Samples work on the Indiana Prospect which consisted of obtaining and analyzing coal samples. Based on the positive outcome of the coring analysis, we elected into Phase II which consists of exploratory work. During 2007, all five pilot producing wells were drilled, completed and put on pump-down production for gas desorption via newly installed pumps, lines and facilities. In addition, a produced water disposal well was drilled and completed to service the pilot wells. Some gas production has begun and is being used throughout the field for fuel gas needs. The extent of water influx is under evaluation to enhance desorption efforts. In 2008, chemical treatments to enhance well fluid productivity was begun with fracture stimulation under evaluation as desorption pump-down continues. Also in 2008, a fracture stimulation was performed to increase desorption pumpdown rates. Alternative design stimulations are under evaluation as pumpdown continues as the initial fracture treatments are evaluated.

We elected to proceed with a second pilot well project. A monitor well was drilled, completed and tested for permeability determination in late 2007. During 2008, five pilot producers and the water disposal well were completed with specialized fracture stimulation completed in late fourth quarter 2008. Currently, we are in the dewatering phase in which the pilot wells are produced to maximize fluid (water) production in order to lower reservoir pressure so that desorption of gas can occur in the pilot test wells on the Indiana Posey Contract area. We continue to evaluate their progress. Following an evaluation period of these two pilot areas, we will evaluate a Phase III Development election and funding of a development well program as contemplated by the agreements.

On the Ohio Cumberland Prospect, we completed Phase I Core Samples work on the Ohio Prospect which consisted of obtaining and analyzing coal samples. With regard to Phase II, we made an additional \$500 thousand prospect acquisition payment and intend to fund the first of two pilot well projects on the Cumberland Prospect. This Phase II project has been temporarily suspended until such time as oil and gas commodity

pricing increases. We continue to focus our efforts on the Indiana Posey Contract.

With low oil and gas commodity prices, resource plays, such as coalbed methane prospects, can become uneconomical particularly since all well, facility and flowline costs as well as operating costs during the dewatering/desorption process must be incurred before revenues can be generated. Our discretionary capital expenditures, including costs related to our coalbed methane prospects, may be curtailed at our discretion in the

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future. Such expenditure curtailments could result in us losing certain prospect acreage or reducing our interest in future development projects.

INVESTMENT IN BRITEWATER INTERNATIONAL, LLC.

In June 2009, we acquired a 19.5% interest in a privately-held company, BWI, formerly referred to as UniPure, with a patented oilfield emulsion breaking OHSOL technology. We are deemed to be the primary beneficiary, and accordingly, we have consolidated the assets and liabilities of BWI as of the investment date. The results of operations for the six months ended December 31, 2009 have been consolidated in our results of operations. See Note 2 Investment in BriteWater International, LLC. in the Notes to Consolidated Financial Statements contained in Part II, Item 8 of this Annual Report on Form 10-K for further information.

INVESTMENT IN GLOBAL

At December 31, 2009 and 2008, we owned approximately 34% of Global's ordinary shares. At December 31, 2009 and 2008, our investment in Global was equal to the market value of our 11.9 million shares of Global's common stock as follows (in thousands, except share amounts):

	December 30, 2009		December 31, 2008
Shares of Global Stock held by HKN	11,893,463		11,893,463
Closing price of Global Stock	£ 0.66	£	0.68
Foreign Currency Exchange Rate	1.6221		1.4619
Market Value of Investment in Global	\$ 12,637	\$	11,824

The foreign currency translation adjustment of approximately \$789 thousand and the unrealized gain on investment of \$24 thousand for these changes in market value between the two periods were recorded to other comprehensive income in stockholders' equity during the year ending December 31, 2009.

Global's asset base and financial information continue to be strong; therefore we intend to hold our shares of Global until the London market improves. For information on Global's operations and financial statements, visit their website at www.globalenergyplc.com.

INVESTMENT IN SPITFIRE

At December 31, 2009 and 2008, we held an investment in Spitfire through the ownership of approximately 25% and 27%, respectively, of Spitfire's currently outstanding common shares. Spitfire is an independent public company (TSX-V; SEL) engaged in the exploration, development and production of crude oil, natural gas and natural gas liquids in Western Canada.

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At December 31, 2009, we owned 9.9 million common shares of Spitfire and 1.3 million warrants to acquire common shares of Spitfire. As a result of our ownership of Spitfire's outstanding common shares, we are deemed to have the ability to exert significant influence over Spitfire's operating and financial policies. Accordingly, we reflect our investment in Spitfire as an equity method investment. Due to timing differences in our filing requirements and the lack of availability of financial information for the current quarterly period, we record our share of Spitfire's financial activity on a three-month lag. During June 2008, our representatives on the Spitfire board of directors resigned due to scheduling and corporate strategy conflicts.

During 2009, we sold approximately 1.2 million of our Spitfire shares in the market for cash proceeds of \$212 thousand. In 2010, we may continue to sell a portion of our Spitfire shares in the market while we pursue strategic alternatives for this Canadian investment. For information on Spitfire's operations and financial statements, visit their website at www.spitfireenergy.com.

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CRITICAL ACCOUNTING ESTIMATES AND ASSUMPTIONS

Our consolidated financial statements have been prepared in accordance with U.S. GAAP which requires us to use estimates and make assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Our estimates and assumptions are based on historical experience, industry conditions and various other factors which we believe are appropriate. Actual results could vary significantly from our estimates and assumptions as additional information becomes known. The more significant critical accounting estimates and assumptions are described below.

Property and Equipment We follow the full cost method of accounting for our investments in oil and natural gas properties. All costs incurred with the acquisition, exploration and development of oil and natural gas properties, including unproductive wells, are capitalized. Under the full cost method of accounting, such costs may be incurred both prior to or after the acquisition of a property and include lease acquisitions, geological and geophysical services, drilling, completion and equipment. Included in capitalized costs are general and administrative costs that are directly related to acquisition, exploration and development activities, and which are not related to production, general corporate overhead or similar activities. For the years 2009, 2008, and 2007, such capitalized general and administrative costs totaled \$295 thousand, \$248 thousand, and \$904 thousand, respectively. General and administrative costs related to production and general overhead are expensed as incurred.

Proceeds from the sale of oil and natural gas properties are credited to the full cost pool, except in transactions where the proceeds received from the sale would significantly alter the relationship between capitalized costs and proved reserves, in which case a gain or loss would be recognized.

Future development, site restoration, and dismantlement and abandonment costs, net of salvage values, are estimated property by property based upon current economic conditions and are included in our amortization of our oil and natural gas property costs.

The provision for depletion and amortization of oil and natural gas properties is computed by the unit-of-production method. Under this computation, the total unamortized costs of oil and natural gas properties (including future development, site restoration, and dismantlement and abandonment costs, net of salvage value), excluding costs of unproved properties, are divided by the total estimated units of proved oil and natural gas reserves at the beginning of the period to determine the depletion rate. This rate is multiplied by the physical units of oil and natural gas produced during the period. Changes in the quantities of our reserves can significantly impact our provision for depletion and amortization of oil and natural gas properties.

The cost of unevaluated oil and natural gas properties not being amortized is assessed quarterly to determine whether such properties have been impaired. In determining impairment, an evaluation is performed on current drilling results, lease expiration dates, current oil and natural gas industry conditions, and available geological and geophysical information. Any impairment assessed is added to the cost of proved properties being amortized. At December 31, 2009, we had approximately \$5.1 million allocated to our unevaluated coalbed methane properties.

Full-Cost Ceiling Test At the end of each quarter, the unamortized cost of oil and natural gas properties, after deducting the asset retirement obligation, net of related deferred income taxes, is limited to the sum of the estimated future net revenues from proved properties using average monthly prices, discounted at 10%, and the lower of cost or fair value of unproved properties adjusted for related income tax effects.

The calculation of the ceiling test and the provision for depletion are based on estimates of proved reserves. There are numerous uncertainties inherent in estimating quantities of proved reserves and in

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projecting the future rates of production, timing, and plan of development. The accuracy of any reserves estimate is a function of the quality of available data and of engineering and geological interpretation and judgment. Results of drilling, testing, and production subsequent to the date of the estimate may justify a revision of such estimate. Accordingly, reserve estimates are often different from the quantities of oil and natural gas that are ultimately recovered.

Based on the twelve (12) month average commodity pricing in 2009 of \$3.87 per Mmbtu for natural gas and \$61.18 per barrel for crude oil, we did not have an impairment of our oil and natural gas properties under the full cost method of accounting. Due to the imprecision in estimating oil and natural gas revenues as well as the potential volatility in oil and natural gas prices and their effect on the carrying value of our proved oil and natural gas reserves, there can be no assurance that write-downs in the future will not be required as a result of factors that may negatively affect the present value of proved oil and natural gas reserves and the carrying value of oil and natural gas properties, including volatile oil and natural gas prices, downward revisions in estimated proved oil and natural gas reserve quantities and unsuccessful drilling activities. For a complete discussion of our proved oil and gas reserves, see Note 16 Oil and Gas Disclosures in the Notes to the Consolidated Financial statements contained in Part II, Item 8 of the Annual Report of Form 10-K.

Fair Value of Financial Instruments Financial instruments are stated at fair value as determined in good faith by management. Factors considered in valuing individual investments may include, without limitation, available market prices, reported net asset values, type of security, purchase price, purchases of the same or similar securities by other investors, marketability, restrictions on disposition, current financial position and operating results, and other pertinent information.

We carry our financial instruments including cash, our investment in ordinary shares of Global and our oil commodity derivative contracts at their estimated fair values. The fair value of our investment in the ordinary shares of Global is based on prices quoted in an active market. The fair values of our oil commodity derivatives are based on pricing provided by our counter parties.

With the exception of our investment in common shares of Spitfire, which is accounted for as an equity method investment, all of our investments in equity securities have been designated as available for sale. Our investment in Global is classified as a non-current asset in our accompanying balance sheets. The associated unrealized gains and losses on our available for sale investments are recorded to other comprehensive income until realized and are reclassified into earnings using specific identification.

Equity Method Investments For investments in which we have the ability to exercise significant influence but do not control, we follow the equity method of accounting. Our equity investment in Spitfire is classified as a non-current asset in our accompanying balance sheets. Initial investments are recorded at cost and adjusted by the proportionate share of the investee's earnings and capital transactions. Our share of investee earnings and our share of their capital transactions are recorded to our income statement. We evaluate these investments for other-than-temporary declines in value each quarter; any impairment found is recognized through earnings.

Translation of Non-U.S. Currency Amounts - Assets and liabilities of our equity investment in Spitfire Energy, whose functional currency is the Canadian dollar, are translated into U.S. dollars at exchange rates in effect at each balance sheet date. Revenue and expense items are translated at average exchange rates prevailing during the periods. Our investment in Global is also subject to foreign currency exchange rate risk as our ownership of Global's ordinary shares are denominated in British sterling pounds. Translation adjustments are included in other comprehensive income until the investment is sold.

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Consolidation of variable interest entities - ASC 810-10-25, *Consolidation*, requires the primary beneficiary of a variable interest entity (VIE) activities to consolidate the VIE and defines a VIE as an entity in which the equity investors do not have substantive voting rights and there is not sufficient equity at

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risk for the entity to finance its activities without additional subordinated financial support. The primary beneficiary is the party that absorbs a majority of the expected losses and/or receives a majority of the expected residual returns of the VIE's activities. We have determined that our investment in BWI meets the requirements of ASC 810-10-25, and we are the primary beneficiary, as defined. Accordingly, we have consolidated the assets and liabilities of BWI as of the investment date. The results of operations for the six months ended December 31, 2009 are consolidated in our results of operations.

As of December 31, 2009, we owned less than a majority of the common shares of Global and did not possess the legal power to direct the operating policies and procedures of Global through our direct ownership, combined with the ownership by Lyford in Global shares. In addition, we have concluded that Global was not a VIE at December 31, 2009 as contemplated by ASC 810-10-25.

Proved Reserves - Our estimates of proved reserves are based on quantities of oil and gas reserves which current engineering data indicates are recoverable from known reservoirs under existing economic and operating conditions. Estimates of proved reserves are key elements in determining our depletion and expense and our full cost ceiling limitation. Estimates of proved reserves are inherently imprecise because of uncertainties in projecting rates of production and timing of developmental expenditures, interpretations of geological, geophysical, engineering and production data and the quality and quantity of available data. Changing economic conditions also may affect our estimates of proved reserves due to changes in developmental costs and changes in commodity prices that may impact reservoir economics. We utilize independent reserve engineers to estimate our proved reserves annually. See Note 16 - Oil and Gas Disclosures in the Notes to Consolidated Financial Statements contained in Part II, Item 8 of this Annual Report on Form 10-K.

Income Taxes We account for income taxes under the liability method. Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. We measure and record income tax contingency accruals in accordance with ASC 740, *Income Taxes*.

We recognize liabilities for uncertain income tax positions based on a two-step process. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step requires us to estimate and measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. It is inherently difficult and subjective to estimate such amounts, as we must determine the probability of various possible outcomes. We reevaluate these uncertain tax positions on a quarterly basis or when new information becomes available to management. These reevaluations are based on factors including, but not limited to, changes in facts or circumstances, changes in tax law, successfully settled issues under audit, expirations due to statutes, and new audit activity. Such a change in recognition or measurement could result in the recognition of a tax benefit or an increase to the tax accrual.

We classify interest related to income tax liabilities as income tax expense, and if applicable, penalties are recognized as a component of income tax expense. The income tax liabilities and accrued interest and penalties that are anticipated to be due within one year of the balance sheet date are presented as current liabilities in our consolidated balance sheets.

During 2008, we received a proposed adjustment to our federal tax liability for the calendar year 2005. We filed a formal protest with the IRS Appeals Office during 2008. In April 2009, we filed our supplement to the written protest which included a third party valuation report supporting the basis of our recognized gain recorded for ACE purposes. Utilizing the process outlined above, we have recorded an

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income tax contingency for this item, including interest and penalties, of \$225 thousand. Although we intend to vigorously defend the proposed adjustment and strongly believe the third party valuation report supports our position and that we have meritorious defenses, if the IRS Appeals Office were to deny all of our protests and our assumptions and estimates associated with this income tax contingency are inaccurate, we could be liable for approximately \$5.7 million in additional tax, penalties and interest.

Fair Value of Derivatives - We are exposed to risk from fluctuations in crude oil and natural gas prices. To reduce the impact of this risk in earnings and to increase the predictability of our cash flow, from time to time we enter into certain derivative contracts, primarily collars and floors for a portion of our oil and gas operations. Fair values of our commodity derivatives are obtained from the third-party broker / dealer portfolio appraisal statement and are used as the primary evidence for the fair value of the financial instrument. Our Spitfire warrants are not exchange-traded derivatives. Management estimates the fair value of these derivatives using the Black Scholes Valuation model. We have not designated any of our derivative instruments as hedges under ASC 815, *Derivatives and Hedging*. All gains and losses related to these positions are recognized in earnings.

Recent Accounting Pronouncements In December 2007, FASB issued guidance related to Business Combinations under ASC 805, *Business Combinations*, and guidance related to the accounting and reporting of noncontrolling interest under ASC 810-10-65-1, *Consolidation*. This guidance significantly changes the accounting for and reporting of business combination transactions and noncontrolling (minority) interests in consolidated financial statements. This guidance became effective January 1, 2009. We applied this guidance to our investment in BWI. Please see Note 2 Investment in BriteWater International, LLC in the Notes to Consolidated Financial Statements for additional information.

In March 2008, the FASB issued guidance related to the disclosures about derivative instruments and hedging activities under FASB ASC 815-10-50, *Derivatives and Hedging*. This guidance requires companies to provide enhanced disclosures about (a) how and why they use derivative instruments, (b) how derivative instruments and related hedged items are accounted for under applicable guidance, and (c) how derivative instruments and related hedged items affect a company's financial position, financial performance, and cash flows. These disclosure requirements are effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Our adoption of ASC 815-10-50 on January 1, 2009 did not have a material impact on our consolidated financial statements. See Note 5 Derivative Instruments in the Notes to Consolidated Financial Statements for additional information.

In June 2008, the FASB issued guidance to evaluate whether an instrument (or embedded feature) is indexed to an entity's own stock under ASC 815-40-15, *Derivatives and Hedging*. The guidance requires entities to evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock in order to determine if the instrument should be accounted for as a derivative under the scope of ASC 815-10-15. This guidance is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. We adopted ASC 815-40-15 beginning January 1, 2009. We applied this guidance to the conversion feature in our Series M Convertible Preferred Stock (Series M Preferred). See Note 5 Derivative Instruments in the Notes to Consolidated Financial Statements for additional information.

In November 2008, the FASB issued guidance related to accounting considerations for equity method investments under ASC 323-10-35, *Investments - Equity Method and Joint Ventures*. This guidance states that an equity method investor shall account for a share issuance by an investee as if the investor had sold a proportionate share of its investment. Any gain or loss to the investor resulting from an investee's share issuance should be recognized in earnings. Previous to this, changes in equity for both issuances and repurchases were recognized in equity. This guidance is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. We adopted ASC 323-10-35

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beginning January 1, 2009. We applied this guidance to our equity investment in Spitfire Energy. See Note 4 – Equity Investment in Spitfire Energy in the Notes to Consolidated Financial Statements for additional information.

In December 2008, the Securities and Exchange Commission published a Final Rule, *Modernization of the Oil and Gas Reporting Requirements*. The new rule permits the use of new technologies to determine proved reserves if those technologies have been demonstrated to lead to reliable conclusions about reserves volumes. The new requirements also allow companies to disclose their probable and possible reserves to investors. In addition, the new disclosure requirements require companies to: (a) report the independence and qualifications of its reserves preparer or auditor; (b) file reports when a third party is relied upon to prepare reserves estimates or conducts a reserves audit; and (c) report oil and gas reserves using an average price based upon the prior 12-month period rather than year-end prices. The use of average prices will affect future impairment and depletion calculations. In January 2010, the FASB issued Accounting Standards Update No. 2010-03, *Oil and Gas Reserve Estimation and Disclosure*, to align the oil and gas reserve estimation and disclosure requirement of the SEC Final Rule with the ASC 932. The new disclosure requirements are effective for annual reports on Form 10-K for fiscal years ending on or after December 31, 2009. Our adoption of this Final rule for this annual reported dated December 31, 2009 affected our oil and gas disclosures but had no material effect on our financial position and results of operations. See Note 16 - Oil and Gas Disclosures in the Notes to Consolidated Financial Statements contained in Part II, Item 8 of this Annual Report on Form 10-K.

In May 2009, the FASB issued guidance related to subsequent events under ASC 855-10, *Subsequent Events*. This guidance sets forth the period after the balance sheet date during which management or a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date, and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. It requires disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, whether that date represents the date the financial statements were issued or were available to be issued. This guidance is effective for interim and annual periods ending after June 15, 2009. We adopted ASC 855-10 in 2009 and have included the required disclosures in our consolidated financial statements. See Note 18 – Subsequent Events in the Notes to Consolidated Financial Statements for additional information.

In June 2009, the FASB issued an amendment to ASC 810-10, *Consolidation*. As a result, in December 2009, the FASB issued ASC 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*. This guidance amends ASC 810-10-15 to replace the quantitative-based risks and rewards calculation for determining which enterprise has a controlling financial interest in a VIE with a primarily qualitative approach focused on identifying which enterprise has the power to direct the activities of a VIE that most significantly impact the entity's economic performance. It also requires ongoing assessments of whether an enterprise is the primary beneficiary of a VIE and requires additional disclosures about an enterprise's involvement in VIEs. This guidance is effective as of the beginning of the reporting entity's first annual reporting period that begins after November 15, 2009 and earlier adoption is not permitted. We are currently evaluating the potential impact, if any, of the adoption of ASC 2009-17 on our consolidated financial statements.

In June 2009, the FASB issued Accounting Standards Update No. 2009-01 which amends ASC 105, *Generally Accepted Accounting Principles*. This guidance states that the ASC will become the source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. Once effective, the Codification's content will carry the same level of authority. Thus, the U.S. GAAP hierarchy will be modified to include only two levels of U.S. GAAP: authoritative and non-authoritative. This is effective for financial statements issued for interim and annual periods ending after September 15, 2009. We adopted ASC 105 as of September 30, 2009 and thus have incorporated the new Codification citations in place of the corresponding references to legacy accounting pronouncements.

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In August 2009, the FASB issued Accounting Standards Update No. 2009-05, *Measuring Liabilities at Fair Value*, which amends ASC 820, *Fair Value Measurements and Disclosures*. This Update provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure the fair value using one or more of the following techniques: a valuation technique that uses the quoted price of the identical liability or similar liabilities when traded as an asset, which would be considered a Level 1 input, or another valuation technique that is consistent with ASC 820. This Update is effective for the first reporting period (including interim periods) beginning after issuance. Thus, we adopted this guidance as of September 30, 2009, which did not have a material impact on our consolidated financial statements.

RESULTS OF OPERATIONS

For the purposes of discussion and analysis, we are presenting a summary of our consolidated results of operations followed by more detailed discussion and analysis of our operating results. The primary components of our net income / (net loss) from continuing operations for each of the years in the three year period ended December 31, 2009, were as follows (in thousands, except per-share data):

	Year Ended December 31,			Year Ended December 31,		
	2009	2008	% Change	2008	2007	% Change
Oil and gas operating profit (1)	\$ 1,594	\$ 11,405	(86)%	\$ 11,405	\$ 11,771	(3)%
Gas sales revenues	\$ 1,542	\$ 6,913	(78)%	\$ 6,913	\$ 7,881	(12)%
Gas production (mcf)	388,153	703,360	(45)%	703,360	986,279	(29)%
Gas price per mcf	\$ 3.97	\$ 9.83	(60)%	\$ 9.83	\$ 7.99	23%
Oil sales revenues	\$ 8,643	\$ 15,293	(43)%	\$ 15,293	\$ 12,538	22%
Oil production (bbls)	147,784	149,414	(1)%	149,414	171,866	(13)%
Oil price per bbl	\$ 58.48	\$ 102.35	(43)%	\$ 102.35	\$ 72.95	40%
Trading losses (2)	\$	\$ (4,344)	100%	\$ (4,344)	\$ 680	(739)%
Other revenues, net	\$ 2,183	\$ 2,401	(9)%	\$ 2,401	\$ 3,199	(25)%
General and administrative expenses, net	\$ 3,197	\$ 5,281	(39)%	\$ 5,281	\$ 5,950	(11)%
Provision for doubtful accounts	\$ 183	\$ 41	346%	\$ 41	\$ (106)	139%
Depreciation, depletion, amortization and accretion	\$ 3,524	\$ 5,224	(33)%	\$ 5,224	\$ 6,107	(14)%
Other losses	\$ 33	\$ 121	(73)%	\$ 121	\$ 390	(69)%
Impairment of investment in Spitfire	\$	\$ 4,618	(100)%	\$ 4,618	\$	100%
Impairment of facilities	\$	\$ 97	(100)%	\$ 97	\$	100%
Full cost pool impairment	\$	\$ 19,906	(100)%	\$ 19,906	\$	100%
Equity in losses (earnings) in Spitfire	\$ 225	\$ (196)	215%	\$ (196)	\$ 50	(492)%
Income tax expense (benefit)	\$ (40)	\$ 275	(115)%	\$ 275	\$ 30	817%
Net income (loss) from continuing operations	\$ (3,345)	\$ (25,905)	(87)%	\$ (25,905)	\$ 3,229	(902)%
Loss from discontinued operations, net of taxes	\$	\$ (841)	100%	\$ (841)	\$	100%
Net loss attributed to noncontrolling interests	\$ 295	\$	100%	\$	\$	100%
Net income (loss) attributed to HKN	\$ (3,050)	\$ (26,746)	(89)%	\$ (26,746)	\$ 3,229	(928)%
Net income (loss) attributed to common stock	\$ (3,469)	\$ (27,108)	(87)%	\$ (27,108)	\$ 2,965	(1014)%
Net income (loss) per common share:						
From continuing operations	\$ (0.37)	\$ (2.74)	86%	\$ (2.74)	\$ 0.30	(1013)%
From discontinued operations	\$	\$ (0.09)	100%	\$ (0.09)	\$	100%
Basic and diluted	\$ (0.37)	\$ (2.83)	87%	\$ (2.83)	\$ 0.30	(1042)%

-
- (1) Oil and gas operating profit is calculated as oil and gas revenues less oil and gas operating expenses
 - (2) The Canergy Fund and Canergy Management segments were deconsolidated from our financial statements during the fourth quarter of 2009. However, both the Canergy Fund and Canergy Management had no results from operations for the year ended December 31, 2009.

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The following is our discussion and analysis of significant components of our continuing operations which have affected our operating results and balance sheet during the periods included in the accompanying consolidated financial statements.

Operating Results:

Oil and Gas Revenues and Oil and Gas Expenses for the Year Ended December 31, 2009 Compared to December 31, 2008

In correlation with lower oil and gas commodity pricing in the markets during 2009, our oil and gas revenues decreased from \$22.2 million in the prior year period to \$10.2 million for the current year period. This decrease was primarily due to the significantly lower oil and gas prices received during the period.

Our natural gas revenues decreased from approximately \$6.9 million during 2008 to \$1.5 million for 2009. The prices realized for natural gas sales decreased 60%, averaging \$3.97 per mcf in during 2009 compared to \$9.83 per mcf during 2008. Natural gas production decreased 45% in 2009 as compared to the prior year period due primarily to decreased production from Lapeyrouse, Raymondville and Lake Raccourci fields. These fields are under evaluation for possible divesture in 2010.

Our oil revenues decreased to approximately \$8.7 million during 2009 from approximately \$15.3 million during 2008. We realized a 43% decrease in oil prices received, decreasing from an average of \$102.35 per barrel in 2008 to \$58.48 per barrel in the current year. Overall oil production remained fairly steady by only decreasing by 1% in 2009 as compared to the prior year due primarily to decreased oil production at our Lake Raccourci and Raymondville fields. These decreases were mostly offset by production gains from our Creole field.

Our oil and gas operating expense decreased 20%, decreasing from approximately \$10.8 million during 2008 to \$8.6 million during 2009 due primarily to lower operating costs at Main Pass 35, lower production taxes which resulted from lower prices realized on our oil and gas sales during the current year, as well as hurricane-related repair costs incurred during 2008.

Oil and Gas Revenues and Oil and Gas Expenses for the Year Ended December 31, 2008 Compared to December 31, 2007

Our oil and gas revenues increased from \$20.4 million in 2007 to \$22.2 million for 2008. This increase was due to the higher oil and gas prices received during the period.

During August and September 2008, two hurricanes hit the Gulf of Mexico Coast effectively shutting in most of the oil & gas production in the Texas and Louisiana coastal area. Production from our operated oil and gas properties (Main Pass 35, Lake Raccourci and Point a la Hache) along with most of our non-operated properties was shut-in during late August and September. The estimated effect of the loss of net oil and gas revenue from the hurricanes was approximately \$3.1million.

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Our natural gas revenues decreased from \$7.9 million in 2007 to \$6.9 million in 2008. The prices realized for natural gas sales increased 23%, averaging \$9.83 per mcf in 2008 compared to \$7.99 per mcf during 2007. The effects of the hurricanes during August and September 2008 contributed to the decrease in our natural gas sales volumes during the year.

Our oil revenues increased to approximately \$15.3 million during 2008 from approximately \$12.5 million during 2007. We realized a 40% increase in oil prices received, increasing from an average of \$72.95 per barrel in 2007 to \$102.35 per barrel in 2008. Overall oil production decreased 13% in 2008 as compared to the prior year due primarily to the effects of the hurricanes.

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Our oil and gas operating expense increased 25%, increasing from approximately \$8.7 million during 2007 to \$10.8 million during the year due primarily to \$1.1 million related to our insurance deductible and repair costs in excess of insured values associated with the hurricanes.

Trading Revenues, net

We had no trading activity during the year ended December 31, 2009. As a result of our trading activities of investments in energy industry securities in 2008 and 2007, we recognized the following net trading revenues (losses) (in thousands):

	December 31, 2008	December 31, 2007
Unrealized loss on written call positions	\$	\$ (50)
Unrealized gain on written put positions		68
Unrealized gain (loss) on written commodity calls	37	(37)
Unrealized gain (loss) on commodity puts	18	(61)
Realized gain (loss) on written put options	(2,795)	919
Realized loss on crude futures	(1,229)	
Realized gain on foreign currency	97	
Realized loss on purchased commodity puts	(16)	(85)
Realized loss on common stock	(535)	(90)
Realized gain on written call positions	79	16
Total trading income (loss)	\$ (4,344)	\$ 680

Fees, Interest and Other Income, net

Fees, interest and other income decreased from \$2.4 million in 2008 to \$2.2 million in 2009, primarily due to lower interest rates earned from cash and treasury securities during 2009 along with a gain from the sale of assets recognized during 2008.

Fees, interest and other income decreased from \$3.2 million during 2007 to \$2.4 million during 2008, primarily due to lower interest income rates during the year.

General and Administrative Expense

General and administrative expenses decreased 39% from \$5.3 million for 2008 to \$3.2 million for 2009 primarily due to continued cost cutting measures which resulted in overall lower salary and personnel costs along with decreased office and consultant expenses.

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General and administrative expenses decreased 11% from \$6 million in 2007 to \$5.3 million for 2008 primarily from overall lower salary and personnel costs due to fewer employees and lower bonuses during 2008 as compared to the prior year period.

Provision for Doubtful Accounts

We recognized a provision for doubtful accounts of approximately \$183 thousand during 2009 compared to \$41 thousand in 2008 primarily due to one of our oil and gas processing and handling customers filing Chapter 11 bankruptcy. We recognized a benefit for doubtful accounts of \$106 thousand in 2007.

Depreciation, Depletion, Amortization and Accretion Expense

Depreciation, depletion, amortization and accretion (DD&A) expense decreased 33% in 2009 when compared to prior year due to lower production volumes. The average depletion rate per boe on our properties decreased from \$17.22 per boe in 2008 to \$15.21 per boe in 2009.

Depreciation, depletion, amortization and accretion (DD&A) expense decreased 14% during 2008 when compared to 2007 due to lower oil and gas production volumes. Our annual depletion rate per boe on our properties increased from \$16.32 to \$17.22 as a result of decreased proved reserve volumes at December 31, 2008.

Impairment of Investment in Spitfire

In 2008, we recognized a \$4.6 million impairment of our equity investment in Spitfire based on the other-than-temporary decline in the fair value of Spitfire's common shares. No such impairment was recognized in 2009 or 2007.

Other Losses

During 2009, 2008 and 2007, we recognized the changes in the fair value of our Spitfire warrants in other losses in our consolidated financials.

Full Cost Impairment

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Due to a decline in oil and gas prices at December 31, 2008, we recorded a non-cash full cost pool impairment of approximately \$19.9 million in 2008 related to our oil and gas properties under the full cost method of accounting. The valuation was based on the present value, discounted at ten percent, of our proved oil and gas reserves based on year-end prices. We had no full cost valuation impairments in 2009 or 2007.

Impairment of Long-Lived Assets

During 2008, we recognized an impairment of approximately \$97 thousand for our Lake Raccourci facility, as the carrying value of such facility was in excess of its fair market value subsequent to the damage it sustained during the Hurricanes. We had no impairments of long-lived assets in 2009 or 2007.

Income Tax Expense

We recognized an income tax benefit of \$40 thousand during 2009 due to an adjustment made in the current period to our 2008 state and federal income tax liability. During 2008, we recognized income tax

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expense of \$271 thousand due primarily to an income tax contingency related to a proposed adjustment to our federal tax liability for the calendar year 2005. See Note 10 *Income Taxes* for further discussion. We had no other income tax contingencies in the current year or 2007.

Accrual of Dividends related to Preferred Stock

All of our preferred stock issues contain dividend provisions. Dividends related to all of our preferred stock are cumulative and may be paid in cash or common stock at our option, depending on the respective preferred agreement. We accrue the dividends at their cash liquidation value and reflect the accrual of dividends as a reduction to net income (loss) to arrive at net income (loss) attributed to common stock. Accruals of dividends related to preferred stock for each of the three years ended December 31, 2009 are as follows:

	2009		2008		2007	
Series G1	\$	12,000	\$	13,000	\$	13,000
Series G2		8,000		8,000		8,000
Series M		260,000		284,000		196,000
Total	\$	280,000	\$	305,000	\$	217,000

Payments of Preferred Stock Dividends and Preferred Stock Redemptions

At December 31, 2009, 2008 and 2007, the following shares of our Preferred Stock issuances were outstanding:

	2009	2008	2007
Series G1	1,000	1,600	1,600
Series G2	1,000	1,000	1,000
Series M		44,000	44,000
Total	2,000	46,600	46,600

Payment of Preferred Stock Dividends During 2009, 2008 and 2007, we paid the accrued dividends related to preferred stock for the Series G1 and G2 Preferred with shares of our common stock issuing approximately 157, 249 and 83 shares, respectively, of our common stock as payment for the accrued dividends related to the Series G1 and G2 Preferred. The difference between the fair value of the shares of our common stock and the carrying value of the dividend liability, net of withholding taxes paid on behalf of the preferred shareholders, is considered a debt extinguishment gain of \$18 thousand, \$29 thousand and \$9 thousand in 2009, 2008 and 2007, respectively, and is reflected as payment of preferred stock dividends as an increase to net income (loss) to arrive at net income (loss) attributed to common stock.

During the three years ended December 31, 2009, the accounting for the modification and payment of dividends of our preferred stocks were reflected as either increases or decreases to net income (loss) attributed

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to common stock. In June 2009 upon issuance of our common shares, the conversion price of the Series M Preferred decreased from \$13.22 to \$11.85 per share. The incremental intrinsic value of the change in the Series M Preferred conversion price of \$76 thousand is reflected as a payment of preferred stock dividends in our consolidated statement of operations for the year ended December 31, 2009.

The net effect of these preferred stock modifications and payments of preferred stock dividends for the three years ended December 31, 2009 is as follows:

	2009		2008		2007	
Series G1	\$	7,000	\$	18,000	\$	6,000
Series G2		8,000		10,000		3,000
Series M		(154,000)		(85,000)		(56,000)
Total	\$	(139,000)	\$	(57,000)	\$	(47,000)

LIQUIDITY AND CAPITAL STRUCTURE**Financial Condition**

(Thousands of dollars)	December 31, 2009		December 31, 2008	
Current ratio		2.74 to 1		5.77 to 1
Working capital (1)	\$	5,989	\$	16,102
Total debt	\$		\$	
Total cash and marketable securities less debt	\$	7,030	\$	15,219
Total stockholders' equity	\$	57,831	\$	59,904
Total liabilities to equity		0.18 to 1		0.15 to 1

(1) Working capital is the difference between current assets and current liabilities.

The decreases in our current ratio and our working capital as of December 31, 2009 as compared to December 31, 2008 are primarily due to the discretionary use of cash for current year capital projects as well as repurchases of our common and preferred shares. We deployed cash of \$4.4 million to redeem 44,000 shares of our Series M Preferred and \$1.9 million to repurchase shares of our common stock during 2009. We have no debt outstanding as of December 31, 2009. We deployed approximately \$2.6 million during the 2009 period for capital projects. The majority of these capital expenditures were used for upgrades and improvements at our Main Pass 35 facility as well as the completion of two producing wells at our Creole field, increasing both our reserves and production from this field.

During 2009, oil and natural gas prices declined sharply as compared to the prior year period. However, we reduced our controllable costs in order to maintain positive cash flow from operations during this low commodity pricing environment. We have a cash balance of approximately \$7 million at December 31,

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2009. In 2010, we anticipate our operating cash flow and other capital resources, if needed, will adequately fund our planned capital expenditures and other capital uses over the near-term. Based on industry outlook for 2010, prices for oil and natural gas are expected to be higher as compared to 2009.

We may continue to deploy cash for discretionary capital expenditures, long-term investments or seek to raise financing through the issuance of debt, equity and convertible debt instruments, if needed, for utilization of acquisition, development or investment opportunities as they arise. We may also reduce our ownership interest in Spitfire s and Global s common shares through strategic sales under certain conditions.

At December 31, 2009, if our remaining convertible preferred stock were converted and the put/call option was exercised, we would be required to issue the following amounts of our common stock:

Instrument	Conversion Price (a)	Shares of Common Stock Issuable at December 31, 2009
Series G1 Preferred	\$ 280.00	357
BWI Put/Call Option		725,000
Series G2 Preferred	\$ 67.20	1,488
Common Stock Potentially Issued Upon Conversion		726,845

(a) Certain conversion prices are subject to adjustment under certain circumstances.

Option to Issue Common Shares In 2009, pursuant to the terms of our investment in BWI and the related Agreement, HKN and the other BWI unitholders granted to one another put and call options with respect to 3,050 units of BWI (or 30.5% of the outstanding units) in exchange for issuance of 725 thousand restricted shares of our common stock. These options are exercisable only if certain conditions are satisfied prior to June 2012. None of these conditions have been met as of December 31, 2009 or as of the date of this filing. Please see Note 2 Investment in BriteWater International, LLC for additional information of our investment.

Significant Ownership of our Stock

As of December 31, 2009, Lyford beneficially owned approximately 33% of the combined voting power of our common stock. Lyford is in a position to exercise significant influence over the election of our board of directors and other matters.

Cash Flows

Net cash flow provided by operating activities during 2009 was \$10.3 million, as compared to net cash used of \$7.3 million in 2008. The increase in cash flow provided by operating activities as compared to the prior year period was primarily caused by a \$9.5 million conversion of

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marketable securities into cash, collection of our previously outstanding hurricane insurance receivable, and a reduction in our operating, general and administrative costs as a result of cost-cutting efforts. Our cash on hand at December 31, 2009 totaled approximately \$7 million.

Net cash used in financing activities during 2009 and 2008 totaled approximately \$6.6 million and \$4.6 million, respectively, due to repurchases of our preferred and common stock. Net cash used in investing

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activities during 2009 totaled approximately \$2.3 million and was primarily comprised of capital expenditures associated with completion costs for two wells in our outside-operated Creole field and upgrades and improvements made at our Main Pass 35 facility.

Obligations and Commitments

Oil, Natural Gas and Coalbed Methane Commitments During 2009, we expended approximately \$2.6 million of capital expenditures and workovers in the United States. The majority of these capital expenditures were associated with completion costs for the Creole field in south Texas and upgrades and improvements made at our Main Pass 35 facility in offshore Louisiana. During 2009, we limited our capital expenditures while oil and natural gas prices remained low. In 2009, industry-wide drilling costs did not reduce in comparison to the dramatic drop in commodity prices. In 2010, we expect to fund our capital expenditures with available cash on hand and through projected cash flow from operations. Our capital expenditures for 2010 are discretionary and, as a result, will be curtailed if sufficient funds are not available. Such expenditure curtailments, however, could result in us losing certain prospect acreage or reducing our interest in future development projects.

BriteWater Contingencies In 2009, BWI recorded a contingent liability of \$800 thousand which may be payable to a vendor upon the conclusion of certain testing events of the OHSOL plant equipment. This contingent liability is included in other accrued liabilities within our consolidated condensed balance sheet.

Deferred Tax Liability In 2009, upon our investment in BWI, we recorded a deferred tax liability in the amount of \$729 thousand, calculated by applying the domestic statutory tax rates to the difference between the book purchase price and the estimated tax basis. Information and research regarding the tax basis of the assets at the date of the acquisition is not complete at this time and the deferred tax may be adjusted as more information becomes available.

Operational Contingencies Our operations are subject to stringent and complex environmental laws and regulations governing the discharge of materials into the environment or otherwise relating to environmental protection. These laws and regulations are subject to changes that may result in more restrictive or costly operations. Failure to comply with applicable environmental laws and regulations may result in the imposition of administrative, civil and criminal penalties or injunctive relief.

We recognize the full amount of asset retirement obligations beginning in the period in which they are incurred if a reasonable estimate of a fair value can be made. At December 31, 2009, our asset retirement obligation liability totaled approximately \$6.2 million.

From time to time, we provide for reserves related to contingencies when a loss is probable and the amount is reasonably estimable.

Consolidated Contractual Obligations The following table presents a summary of our consolidated contractual obligations and commercial commitments as of December 31, 2009 (in thousands):

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Contractual Obligations	2010		2011		Payments Due by Period		Thereafter	Total		
					2012	2013				
Office Leases	\$	189	\$	78	\$	\$	\$	\$ 267		
Oil, Gas and Coalbed Methane Commitments (1)	\$		\$		\$	\$	\$			
Asset Retirement Obligation	\$	43	\$	378	\$	197	\$	137	\$ 5,438	6,193
Total Contractual Cash Obligations	\$	232	\$	456	\$	197	\$	137	\$ 5,438	\$ 6,460

(1) Our 2010 capital expenditures are discretionary and, as a result, will be curtailed if sufficient funds are not available.

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In addition to the above commitments, during 2009 and afterward, government authorities under our Louisiana state leases and other operators may also request us to participate in the cost of drilling additional exploratory and development wells. We may fund these future expenditures at our discretion. Further, the cost of drilling or participating in the drilling of any such exploratory and development wells cannot be quantified at this time since the cost will depend on factors out of our control, such as the timing of the request, the depth of the wells and the location of the property. As of December 31, 2009, we had no material purchase obligations.

Off-Balance Sheet Arrangements As part of our ongoing business, we do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities (SPEs), which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As of December 31, 2009, we were not involved in any unconsolidated SPE transactions. We have no off-balance sheet arrangements.

Treasury Stock In January 2009, our Board of Directors authorized an amendment to the existing repurchase plan allowing us to repurchase an additional 1 million shares of our common stock. During the year ended December 31, 2009, we repurchased approximately 708 thousand shares of our common stock. This included a repurchase of 500 thousand shares of our common stock for \$1.3 million from a shareholder in a privately negotiated transaction pursuant to our repurchase program. During the year ended December 31, 2009, we retired approximately 715 thousand treasury shares. As of December 31, 2009 approximately 530 thousand shares remained available for repurchase under our repurchase program.

During 2008, we repurchased 507 thousand shares of our common stock in the open market at a cost of approximately \$4.4 million pursuant to our repurchase program. In 2008, we cancelled 500 thousand of these shares. At December 31, 2008, we held 6,869 shares of treasury stock, and approximately 237 thousand shares remained available for repurchase under our repurchase program.

Redemption of Series M Preferred During 2009, we redeemed all 44 thousand shares of our Series M Preferred with a liquidation value of \$100 per share for \$4.4 million in cash. In addition, we paid approximately \$124 thousand in accrued dividends on these shares.

Redemption of Series G1 Preferred During 2009, we redeemed six hundred shares of our Series G1 Preferred with a liquidation value of \$100 per share and 18 Common stock for \$5 thousand in cash. In addition, we paid approximately \$2 thousand in accrued dividends on these shares.

Adequacy of Capital Sources and Liquidity

We believe that we have the ability to provide for our operational needs, our planned capital expenditures and possible investments through projected operating cash flow and cash on hand. Our operating cash flow would be adversely affected by continued declines in oil and natural gas prices, which can be volatile. However, we have worked to reduce our controllable costs in order to maintain positive cash flow from operations during this low commodity pricing environment. Should projected operating cash flow decline, we may further reduce our capital expenditures and possible investments and/or consider the issuance of debt, equity and convertible debt instruments, if needed, for utilization for the capital expenditure program or possible energy-based investment opportunities. We may also continue to reduce our ownership interest in Spitfire s and Global s common shares through strategic sales under certain conditions.

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We have no debt outstanding at December 31, 2009. If we seek to raise equity or debt financing to fund capital expenditures or other acquisition and development opportunities, those transactions may be affected by the market value of our common stock. If the price of our common stock declines, our ability to utilize our stock either directly or indirectly through convertible instruments for raising capital could be negatively affected. Further, raising additional funds by issuing common stock or other types of equity securities could dilute our existing stockholders, which dilution could be substantial if the price of our common stock decreases. Any securities we issue may have rights, preferences and privileges that are senior to our existing equity securities. Borrowing money may also involve pledging some or all of our assets.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The following financial statements appear on pages 33 through 67 in this Annual Report.

	Page
<u>Report of Independent Registered Public Accounting Firms</u>	33
<u>Consolidated Balance Sheets December 31, 2009 and 2008</u>	34
<u>Consolidated Statements of Operations Years ended December 31, 2009, 2008 and 2007</u>	35
<u>Consolidated Statements of Stockholders Equity Years ended December 31, 2009, 2008 and 2007</u>	36
<u>Consolidated Statements of Cash Flows Years ended December 31, 2009, 2008 and 2007</u>	37
<u>Notes to Consolidated Financial Statements</u>	38

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors

HKN, Inc.

We have audited the accompanying consolidated balance sheets of HKN, Inc as of December 31, 2009 and 2008, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of HKN, Inc. as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), HKN, Inc.'s internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated February 18, 2010 expressed an unqualified opinion on the effectiveness of HKN, Inc.'s internal control over financial reporting.

HEIN & ASSOCIATES LLP

Dallas, Texas

February 18, 2010

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HKN, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except for share amounts)

	December 31, 2009	December 31, 2008
Assets		
Current Assets:		
Cash and temporary investments	\$ 7,030	\$ 5,722
Marketable securities (Treasury bills)		9,497
Accounts receivable, net	1,969	3,778
Prepaid expenses and other current assets	433	482
Total Current Assets	9,432	19,479
Unevaluated oil and gas properties	5,099	4,874
Evaluated oil and gas properties, net	29,355	29,628
OHSOL equipment, net	7,027	
Other equipment, net	697	856
Property and Equipment, net	42,178	35,358
Intangible assets	1,946	
Investment in Global	12,637	11,824
Investment in Spitfire, equity method	1,608	1,820
Other Assets	414	292
	\$ 68,215	\$ 68,773
Liabilities and Stockholders' Equity		
Current Liabilities:		
Trade payables	\$ 498	\$ 639
Accrued liabilities and other	2,153	1,826
Income tax contingency	225	225
Revenues and royalties payable	567	687
Total Current Liabilities	3,443	3,377
Asset Retirement Obligation	6,193	5,472
Deferred Income Taxes	748	20
Total Liabilities	10,384	8,869
Commitments and Contingencies (Note 17)		
Stockholders' Equity:		
Series G1 Preferred Stock, \$1.00 par value; \$100 thousand and \$160 thousand liquidation value, respectively; 700,000 shares authorized; 1,000 and 1,600 shares outstanding, respectively	1	2
Series G2 Preferred Stock, \$1.00 par value; \$100 thousand liquidation value 100,000 shares authorized; 1,000 shares outstanding	1	1
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Series M Preferred Stock, \$1.00 par value; \$0 and \$4.4 million liquidation value, respectively;

50,000 shares authorized; 0 and 44,000 shares outstanding, respectively

Common stock, \$0.01 par value; 24,000,000 shares authorized; 9,553,847 and 9,268,253

shares issued, respectively	96	93
Additional paid-in capital	437,877	442,642
Accumulated deficit	(388,644)	(385,171)
Accumulated other comprehensive income	3,213	2,312
Treasury stock, at cost, 0 and 6,869 shares held, respectively		(19)
Total HKN, Inc. Stockholders Equity	52,544	59,904
Noncontrolling interest	5,287	
Total Stockholders Equity	57,831	59,904
	\$ 68,215	\$ 68,773

The accompanying Notes to Consolidated Financial Statements are an integral part of these Statements.

Table of Contents**HKN, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands except for share and per share amounts)

	2009	Year Ended December 31,		2007
		2008		
Revenues and other:				
Domestic oil and gas operations	\$ 10,185	\$ 22,206	\$	20,419
Trading revenues (losses), net		(4,344)		680
Interest and other income	2,183	2,401		3,199
	12,368	20,263		24,298
Costs and Expenses:				
Domestic oil and gas operating expenses	8,591	10,801		8,648
General and administrative expenses	3,197	5,281		5,950
Provision (benefit) for doubtful accounts	183	41		(106)
Depreciation, depletion, amortization and accretion	3,524	5,224		6,107
Equity in losses (gains) of Spitfire	225	(196)		50
Impairment of facilities		97		
Impairment of investment in Spitfire		4,618		
Full cost impairment		19,906		
Interest expense and other losses	33	121		390
	15,753	45,893		21,039
Income (loss) from continuing operations before income taxes	\$ (3,385)	\$ (25,630)	\$	3,259
Income tax expense (benefit)	(40)	275		30
Income (loss) from continuing operations	\$ (3,345)	\$ (25,905)	\$	3,229
Loss from discontinued operations, net of taxes		(1,049)		
Net income (loss)	\$ (3,345)	\$ (26,954)	\$	3,229
Net loss attributable to noncontrolling interests	295			
Net loss from discontinued operations attributable to noncontrolling interests		208		
Net income (loss) attributable to HKN, Inc.	\$ (3,050)	\$ (26,746)	\$	3,229
Accrual of dividends related to preferred stock	(280)	(305)		(217)
Payments of dividends and modification of preferred stock and common stock warrants				
	(139)	(57)		(47)
Net income (loss) attributed to common stock	\$ (3,469)	\$ (27,108)	\$	2,965
Basic and diluted net income (loss) per common share:				
Net income (loss) per common share from continuing operations	\$ (0.37)	\$ (2.74)	\$	0.30
Net loss per common share from discontinued operations		(0.09)		
Net income (loss) per common share	\$ (0.37)	\$ (2.83)	\$	0.30
Weighted average common shares outstanding	9,269,565	9,587,952		9,799,332

The accompanying Notes to Consolidated Financial Statements are an integral part of these Statements.

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HKN, INC.

CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

(in thousands)

	Preferred Stock			Common	Additional	Treasury	Noncontrolling	Accumulated	Accumulated	Other	Total
	G1	G2	M	Stock	Paid-In	Stock	Interest	Deficit	Comprehensive	Income	
Balance, December 31, 2006	\$ 2	\$ 1	\$ 44	\$ 100	\$ 449,218	\$ (1,670)	\$	\$ (361,028)	\$ 18,334	\$	\$ 105,001
Accrual of preferred stock dividends								(264)			(264)
Issuance of preferred stock dividends					1						1
Reverse stock split					(10)						(10)
Treasury stock repurchase						(679)					(679)
Treasury stock retirements				(2)	(2,347)	2,349					
Equity in stock issuances by Spitfire					111						111
Comprehensive loss:											
Net income								3,229			
Unrealized holding loss on available for sale investments										(8,469)	
Reclassification of holding loss on available for sale investment into earnings										207	
Unrealized foreign currency gain										639	
Total comprehensive loss											(4,394)
Balance, December 31, 2007	\$ 2	\$ 1	\$ 44	\$ 98	\$ 446,973	\$	\$	\$ (358,063)	\$ 10,711	\$	\$ 99,766
Accrual of preferred stock dividends								(362)			(362)
Issuance of preferred stock dividends					2						2
Treasury stock repurchase						(4,404)					(4,404)
Treasury stock retirements				(5)	(4,380)	4,385					
Equity in stock issuances by Spitfire					47						47
Comprehensive loss:											
Net loss								(26,746)			
Unrealized holding loss on available for sale investments										(2,172)	
Unrealized foreign currency loss										(6,227)	
Total comprehensive loss											(35,145)
Balance, December 31, 2008	\$ 2	\$ 1	\$ 44	\$ 93	\$ 442,642	\$ (19)	\$	\$ (385,171)	\$ 2,312	\$	\$ 59,904
Issuance of restricted shares related to investment, net of issuance costs of \$35 thousand					10	1,307					1,317
Cumulative effect of Series M Preferred conversion feature								(4)			(4)
Adjustment of Series M conversion price						76		(76)			
Accrual of preferred stock dividends								(280)			(280)
						1		(63)			(62)

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Issuance of preferred stock dividends																
Preferred stock redemption	(1)	(44)	(4,356)											(4,401)		
Treasury stock repurchase								(1,890)						(1,890)		
Treasury stock retirements			(7)	(1,902)	1,909											
Equity in stock repurchases by Spitfire					109									109		
Comprehensive loss:																
Net loss														(3,050)		
Unrealized holding gain on available for sale investments														24		
Unrealized foreign currency gain														877		
Total comprehensive loss														(2,149)		
Noncontrolling interest in investment													5,287	5,287		
Balance, December 31, 2009	\$	1	\$	1	\$	96	\$	437,877	\$	5,287	\$	(388,644)	\$	3,213	\$	57,831

The accompanying Notes to Consolidated Financial Statements are an integral part of these Statements.

Table of Contents**HKN, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)**

	2009	For the Year Ended 2008		2007
Cash flows from operating activities:				
Net income (loss)	\$ (3,345)	\$ (26,954)		\$ 3,229
Adjustments to reconcile net income (loss) to net cash (used) provided by operating activities:				
Depreciation, depletion, amortization and accretion	3,524	5,224		6,107
Loss on trading investments		534		91
Loss (gain) on trading derivatives		3,810		(779)
Equity in losses (gains) of Spitfire	225	(196)		50
Realized gain from sale of Spitfire shares	(30)			
Impairment of investment in Spitfire		4,618		
Impairment of facilities		97		
Full cost impairment		19,906		
Operating cash flows from discontinued operations		804		
Other		(224)		(117)
Change in operating assets and liabilities:				
Decrease (increase) in marketable securities	9,497	(9,497)		5,000
Decrease in accounts receivable and other	1,796	537		4,211
Decrease in margin deposits posted with brokers		123		587
(Decrease) increase in derivative liabilities		(3,872)		388
Decrease in trade payables and other	(1,385)	(2,231)		(6,299)
Net cash provided (used) by operating activities	10,282	(7,321)		12,468
Cash flows from investing activities:				
Net proceeds from sales of assets		337		1,281
Capital expenditures	(2,552)	(6,896)		(10,867)
Sales of investments		2,265		1,530
Purchase of available for sale investments		(1,634)		
Investing cash flows from discontinued operations		(1,969)		
Purchase of common shares in Spitfire		(77)		(3,900)
Proceeds from sale of Spitfire common shares	212			
Net cash used in investing activities	(2,340)	(7,974)		(11,956)
Cash flows from financing activities:				
Redemption of preferred stock	(4,401)			
Financing cash flows from discontinued operations		208		
Payments of preferred dividends	(343)	(368)		(196)
Cash paid for partial shares in reverse split				(10)
Treasury shares purchased	(1,890)	(4,404)		(679)
Net cash used in financing activities	(6,634)	(4,564)		(885)
Net increase (decrease) in cash and temporary investments	1,308	(19,859)		(373)
Cash and temporary investments at beginning of year	5,722	25,581		25,954
Cash and temporary investments at end of year	\$ 7,030	\$ 5,722		\$ 25,581

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The accompanying Notes to Consolidated Financial Statements are an integral part of these Statements.

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HKN, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

HKN, Inc. (HKN) (a Delaware Corporation) is an independent energy company engaged both in the development and production of crude oil, natural gas and coalbed methane assets and in the management of investments in energy industry securities. Our crude oil and natural gas operations consist of development and production efforts in the United States, principally in the onshore and offshore Gulf Coast regions of South Texas and Louisiana, as well as coalbed methane exploration and development activities in Indiana and Ohio.

At December 31, 2009, we held an investment in Global Energy Development PLC (Global) through our ownership of approximately 34% of Global s ordinary shares which we account for as a cost method investment. Global is a petroleum exploration and production company focused on Latin America. Global s shares are traded on the AIM, a market operated by the London Stock Exchange.

At December 31, 2009, we also held an investment in Spitfire Energy Ltd. (Spitfire) through the ownership of approximately 25% of Spitfire s currently outstanding common shares. Spitfire is an independent public company (TSX-V; SEL) engaged in the exploration, development and production of crude oil, natural gas and natural gas liquids in Western Canada. Our consolidated financial statements retroactively reflect the effect of the change in the accounting for our investment in Spitfire from the cost method to the equity method.

Principles of Consolidation and Presentation - The consolidated financial statements include the accounts of HKN and all of the companies that we, through our direct or indirect ownership or share holding, were provided the ability to control the operating policies and procedures. All significant intercompany balances and transactions have been eliminated. During the fourth quarter of 2009, we discontinued operations of the Canergy Growth Fund and Canergy Management from our consolidated financial statements. We reflected the deconsolidation retrospectively. See Note 13 Discontinued Operations for further discussion.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Significant estimates are required for proved oil and gas reserves which, as described in Note 7 Oil and Gas Properties, may have a material impact on the carrying value of oil and gas property. Actual results could differ from those estimates and such differences could be material. Certain prior year amounts have been reclassified to conform with the 2009 presentation.

Consolidation of Variable Interest Entity - Our investment in BriteWater International, LLC (BWI), formerly referred to as UniPureEnergy, is considered to be a variable interest, as defined in ASC 810-10, *Consolidation*. ASC 810-10-25 requires the primary beneficiary of a variable interest entity s (VIE) activities to consolidate the VIE. ASC 810-10-15 defines a VIE as an entity in which the equity investors do not have substantive voting rights and there is not sufficient equity at risk for the entity to finance its activities without additional subordinated financial

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support. We have determined that our investment in BWI meets the requirements of ASC 810-10, and we are the primary beneficiary, as defined. Accordingly, we began consolidating the assets and liabilities of BWI as of June 30, 2009 (the investment date). The results of operations for the six months ended December 31, 2009 are consolidated in our results of operations.

Our investments in the Canergy Growth Fund and Canergy Management were variable interests, as defined in ASC 810-10, and we were the primary beneficiary, as defined. Therefore, we consolidated the assets, liabilities and results of operations of the Canergy Growth Fund for the period from May 14, 2008, the

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formation date, through the third quarter of 2009. During the fourth quarter of 2009, we discontinued operations of the Canergy Growth Fund and Canergy Management. In 2009, we have retrospectively reported the assets, liabilities and results of operations of the Canergy Growth Fund and Canergy Management as discontinued operations in our consolidated financial statements.

Statement of Cash Flows - For purposes of the Consolidated Statements of Cash Flows, we consider all highly liquid investments and treasury bills purchased with an original maturity of three months or less to be cash equivalents. We paid no cash for interest during 2009, 2008 and 2007. Treasury bills with original maturities of greater than three months are classified as marketable securities. At December 31, 2009 and 2008, we held zero marketable securities and \$9.5 million in marketable securities, respectively.

Concentrations of Credit Risk - Although our cash and temporary investments and accounts receivable are exposed to potential credit loss, we do not believe such risk to be significant. Cash and temporary investments include investments in certificates of deposit and money markets placed with highly rated financial institutions. Most of our accounts receivable are from a broad and diverse group of industry partners, many of which are major oil and gas companies and do not in total represent a significant credit risk.

Hurricane Damage Repairs In 2008, we recognized \$1.1 million as expense damages incurred from hurricanes Gustav and Ike primarily related to our insurance deductible and repair costs in excess of insured values. At December 31, 2008, our remaining insurance claim receivable was \$1.4 million on our consolidated balance sheet. These insurance proceeds were received in early 2009.

Allowance for Doubtful Accounts - Accounts receivable are customer obligations due under normal trade terms. We sell our oil and gas production to companies involved in the transportation and refining of crude oil and natural gas. Our net trade receivables from our oil and gas production were approximately \$1.7 million and \$2.1 million at December 31, 2009 and 2008, respectively. We perform continuing credit evaluations of our customers' financial condition, and, although we generally do not require collateral, letters of credit may be required from our customers in certain circumstances.

Senior management reviews accounts receivable to determine if any receivables will potentially be uncollectible. We include provisions for any accounts receivable balances that are determined to be uncollectible in the allowance for doubtful accounts. After all attempts to collect a receivable have failed, the receivable is written off against the allowance. One of our oil and gas processing and handling customers filed for Chapter 11 bankruptcy in 2009, and we accrued a provision for the receivable balances associated with their account. Based on the information available, we believe the allowance for doubtful accounts of \$181 thousand as of December 31, 2009 is adequate. However, actual write-offs could exceed the recorded allowance.

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Comprehensive Income (Loss) Comprehensive income (loss) includes changes in stockholders' equity during the periods that do not result from transactions with stockholders. Our total comprehensive income (loss) is as follows (in thousands):

	Years Ended December 31,		
	2009	2008	2007
Net (loss) income attributable to HKN	\$ (3,050)	\$ (26,746)	\$ 3,229
Foreign currency translation adjustment on investment	877	(6,227)	639
Reclassification of holding gain on available for sale investments into earnings			207
Unrealized (loss) gain on investments	24	(2,172)	(8,469)
Total comprehensive loss	\$ (2,149)	\$ (35,145)	\$ (4,394)

Financial Instruments - We carry our financial instruments including cash and our common stock investment in Global Energy Development PLC (Global) at their estimated fair values. Our investment in ordinary shares of Global has been designated as available for sale, not as a trading security. The associated unrealized gains and losses on our available for sale investments are recorded to other comprehensive income until realized and are reclassified into earnings using specific identification.

Derivative Instruments - We have not designated any of our derivative instruments as hedges under *FASB Accounting Standards Codification* (ASC) 815, *Derivatives and Hedging*. All gains and losses related to our derivative instruments are recognized in Other losses (gains). Please see Note 5 - Derivative Instruments for additional information.

Equity Method Investments - For investments in which we have the ability to exercise significant influence but do not control, we follow the equity method of accounting. Initial investments are recorded at cost and adjusted by the proportionate share of the investee's earnings and capital transactions. Our share of investee earnings and our share of their capital transactions are recorded to our income statement. We evaluate these investments for other-than-temporary declines in value each quarter; any impairment found to be other than temporary is recorded through earnings. Please see Note 4 - Equity Investment in Spitfire Energy for additional information.

Translation of Non-U.S. Currency Amounts - Assets and liabilities of our equity investment in Spitfire, whose functional currency is the Canadian dollar, are translated into U.S. dollars at exchange rates in effect at each balance sheet date. Revenue and expense items are translated at average exchange rates prevailing during the periods. Our investment in Global is also subject to foreign currency exchange rate risk as our ownership of Global's ordinary shares are denominated in British sterling pounds. Translation adjustments are included in other comprehensive income until the investment is sold.

Property and Equipment - We follow the full cost method of accounting for our investments in oil and natural gas properties. All costs incurred in the acquisition, exploration and development of oil and natural gas properties, including unproductive wells, are capitalized. Included in capitalized costs are general and administrative costs that are directly related with acquisition, exploration and development activities. Amortization of unevaluated property costs begins when the properties become proved or their values become impaired. Under the rules of full cost method of accounting, the net carrying value of oil and natural gas properties, reduced by the asset retirement obligation, is limited to the sum of the present value (10% discount rate) of the estimated future net cash flows from proved reserves, based on the previous twelve (12) month average prices and costs, plus the lower of cost or estimated fair market value of unproved properties adjusted for related income tax effects.

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Capitalized costs of proved oil and natural gas properties are depleted on a units of production method using proved oil and natural gas reserves. Such depletion of our domestic oil and gas properties was \$2.30, \$2.87 and \$2.72 per equivalent Mcf produced during 2009, 2008 and 2007, respectively. Costs depleted include net capitalized costs subject to depletion and estimated future dismantlement, restoration, and abandonment costs. Estimated future abandonment, dismantlement and site restoration costs include costs to dismantle, relocate and dispose of our offshore production platforms, gathering systems, wells and related structures, considering related salvage values.

Other property and equipment, which includes computer equipment, computer hardware and software, furniture and fixtures, leasehold improvements and two automobiles, is recorded at cost and is generally depreciated on a straight-line basis over the estimated useful lives of the assets, which range in periods of three to eighteen years. We have recorded accumulated depreciation related to our other property and equipment of \$536 thousand and \$449 thousand at December 31, 2009 and 2008, respectively. Repairs and maintenance are charged to expense as incurred.

Sales of Oil and Gas Properties - We account for sales of oil and gas properties as adjustments of capitalized costs to the full cost pool, with no gain or loss recognized, unless such adjustments would significantly alter the relationship between capitalized costs and proved reserves of oil and gas attributable to the full cost pool. During 2009 and 2008, we did not sell any oil and gas properties. During 2007, we sold certain of our oil and gas properties at auction for net cash proceeds of approximately \$1.3 million and no gain or loss was recognized from the sale.

Intangible Assets We assess the recoverability of our intangible assets at least annually or whenever events or changes in circumstances indicate the carrying amount of the intangible assets may not be fully recoverable. Recoverability is measured by a comparison of the carrying value of the intangible asset over its fair value. Any excess of the carrying value of the intangible asset over its fair value is recognized as an impairment loss. The estimated fair value is determined based on a discounted cash flow model. However, at December 31, 2009, our intangible assets consisted of patents acquired in connection with the investment in BWI. The fair value of these patents was estimated based on the historical cost of the patents and the final valuation is pending a third party valuation. Impairment losses are recorded in other operating expenses. No such impairment was recognized as of December 31, 2009.

Other Assets At December 31, 2009, other assets included \$410 thousand of prepaid drilling costs. During 2008, we sold other assets for cash proceeds of approximately \$337 thousand and recognized a gain on the sale of \$182 thousand. At December 31, 2008, other assets included \$287 thousand of prepaid drilling costs.

Provision for Asset Impairments - Assets that are used in our operations and not held for resale, are carried at cost, less accumulated depreciation and amortization. We review our long-lived assets, other than our investment in oil and gas properties, whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. When evidence indicates that operations will not produce sufficient cash flows to cover the carrying amount of the related asset, and when the carrying amount of the related asset cannot be realized through sale, a permanent impairment is recorded and the asset value is written down to fair value. As a result of the hurricane damages in late 2008, we recorded an impairment to our Lake Raccourci facilities of \$97 thousand at December 31, 2008.

General and Administrative Expenses We reflect general and administrative expenses net of operator overhead charges and other amounts billed to joint interest owners. General and administrative expenses are net of \$295 thousand, \$286 thousand and \$276 thousand for such amounts during 2009, 2008 and 2007, respectively.

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Revenue Recognition - We use the sales method of accounting for natural gas and crude oil revenues. Under this method, revenues are recognized based on actual volumes of oil and gas sold to purchasers. The volumes sold may differ from the volumes to which we are entitled based on our interests in the properties. Approximately 46% of our 2009 oil and gas production was from wells operated by outside parties. With respect to these properties, we typically receive actual sales information approximately sixty to ninety days after the date of sale on these properties. With respect to these non-operated properties, our estimates of production and revenue may differ from actual production and revenues received. Differences can create imbalances that are recognized as a liability only when the estimated remaining reserves will not be sufficient to enable the under produced owner to recoup its entitled share through production. There are no significant balancing arrangements or obligations related to our operations.

Income Taxes We account for income taxes under the liability method. Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. We measure and record income tax contingency accruals in accordance with ASC 740, *Income Taxes*.

We recognize liabilities for uncertain income tax positions based on a two-step process. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step requires us to estimate and measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. It is inherently difficult and subjective to estimate such amounts, as we must determine the probability of various possible outcomes. We reevaluate these uncertain tax positions on a quarterly basis or when new information becomes available to management. These reevaluations are based on factors including, but not limited to, changes in facts or circumstances, changes in tax law, successfully settled issues under audit, expirations due to statutes, and new audit activity. Such a change in recognition or measurement could result in the recognition of a tax benefit or an increase to the tax accrual.

We classify interest related to income tax liabilities as income tax expense, and if applicable, penalties are recognized as a component of income tax expense. The income tax liabilities and accrued interest and penalties that are anticipated to be due within one year of the balance sheet date are presented as current liabilities in our condensed consolidated balance sheets.

Recent Accounting Pronouncements In December 2007, FASB issued guidance related to Business Combinations under ASC 805, *Business Combinations*, and guidance related to the accounting and reporting of noncontrolling interest under ASC 810-10-65-1, *Consolidation*. This guidance significantly changes the accounting for and reporting of business combination transactions and noncontrolling (minority) interests in consolidated financial statements. This guidance became effective January 1, 2009. We applied this guidance to our investment in BWI, formerly referred to as UniPure. Please see Note 2 Investment in BriteWater International, LLC in the Notes to Consolidated Financial Statements for additional information.

In March 2008, the FASB issued guidance related to the disclosures about derivative instruments and hedging activities under FASB ASC 815-10-50, *Derivatives and Hedging*. This guidance requires companies to provide enhanced disclosures about (a) how and why they use derivative instruments, (b) how derivative instruments and related hedged items are accounted for under applicable guidance, and (c) how derivative instruments and related hedged items affect a company's financial position, financial performance, and cash flows. These disclosure requirements are effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Our adoption of ASC 815-10-50 on January 1, 2009 did not have a material impact on our consolidated financial statements. See Note 5 Derivative Instruments in the Notes to Consolidated Financial Statements for additional information.

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In June 2008, the FASB issued guidance to evaluate whether an instrument (or embedded feature) is indexed to an entity's own stock under ASC 815-40-15, *Derivatives and Hedging*. The guidance requires entities to evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock in order to determine if the instrument should be accounted for as a derivative under the scope of ASC 815-10-15. This guidance is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. We adopted ASC 815-40-15 beginning January 1, 2009. We applied this guidance to the conversion feature in our Series M Convertible Preferred Stock (Series M Preferred). See Note 5 - Derivative Instruments in the Notes to Consolidated Financial Statements for additional information.

In November 2008, the FASB issued guidance related to accounting considerations for equity method investments under ASC 323-10-35, *Investments - Equity Method and Joint Ventures*. This guidance states that an equity method investor shall account for a share issuance by an investee as if the investor had sold a proportionate share of its investment. Any gain or loss to the investor resulting from an investee's share issuance should be recognized in earnings. Previous to this, changes in equity for both issuances and repurchases were recognized in equity. This guidance is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. We adopted ASC 323-10-35 beginning January 1, 2009. We applied this guidance to our equity investment in Spitfire Energy. See Note 4 - Equity Investment in Spitfire Energy in the Notes to Consolidated Financial Statements for additional information.

In December 2008, the Securities and Exchange Commission published a Final Rule, *Modernization of the Oil and Gas Reporting Requirements*. The new rule permits the use of new technologies to determine proved reserves if those technologies have been demonstrated to lead to reliable conclusions about reserves volumes. The new requirements also allow companies to disclose their probable and possible reserves to investors. In addition, the new disclosure requirements require companies to: (a) report the independence and qualifications of its reserves preparer or auditor; (b) file reports when a third party is relied upon to prepare reserves estimates or conducts a reserves audit; and (c) report oil and gas reserves using an average price based upon the prior 12-month period rather than year-end prices. The use of average prices will affect future impairment and depletion calculations. In January 2010, the FASB issued Accounting Standards Update No. 2010-03, *Oil and Gas Reserve Estimation and Disclosure*, to align the oil and gas reserve estimation and disclosure requirement of the SEC Final Rule with the ASC 932. The new disclosure requirements are effective for annual reports on Form 10-K for fiscal years ending on or after December 31, 2009. Our adoption of this Final rule for this annual reported dated December 31, 2009 affected our oil and gas disclosures but had no material effect on our financial position and results of operations. See Note 16 - Oil and Gas Disclosures in the Notes to Consolidated Financial Statements.

In May 2009, the FASB issued guidance related to subsequent events under ASC 855-10, *Subsequent Events*. This guidance sets forth the period after the balance sheet date during which management or a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date, and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. It requires disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, whether that date represents the date the financial statements were issued or were available to be issued. This guidance is effective for interim and annual periods ending after June 15, 2009. We adopted ASC 855-10 beginning June 30, 2009 and have included the required disclosures in our consolidated financial statements. See Note 18 - Subsequent Events in the Notes to Consolidated Financial Statements for additional information.

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In June 2009, the FASB issued an amendment to ASC 810-10, *Consolidation*. As a result, in December 2009, the FASB issued ASC 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*. This guidance amends ASC 810-10-15 to replace the quantitative-based risks and rewards calculation for determining which enterprise has a controlling financial interest in a VIE with a primarily qualitative approach focused on identifying which enterprise has the power to direct the activities of a VIE that most significantly impact the entity's economic performance. It also requires ongoing assessments of whether an enterprise is the primary beneficiary of a VIE and requires additional disclosures about an enterprise's involvement in VIEs. This guidance is effective as of the beginning of the reporting entity's first annual reporting period that begins after November 15, 2009 and earlier adoption is not permitted. We are currently evaluating the potential impact, if any, of the adoption of ASC 2009-17 on our consolidated financial statements.

In June 2009, the FASB issued Accounting Standards Update No. 2009-01 which amends ASC 105, *Generally Accepted Accounting Principles*. This guidance states that the ASC will become the source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. Once effective, the Codification's content will carry the same level of authority. Thus, the U.S. GAAP hierarchy will be modified to include only two levels of U.S. GAAP: authoritative and non-authoritative. This is effective for financial statements issued for interim and annual periods ending after September 15, 2009. We adopted ASC 105 as of September 30, 2009 and thus have incorporated the new Codification citations in place of the corresponding references to legacy accounting pronouncements.

In August 2009, the FASB issued Accounting Standards Update No. 2009-05, *Measuring Liabilities at Fair Value*, which amends ASC 820, *Fair Value Measurements and Disclosures*. This Update provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure the fair value using one or more of the following techniques: a valuation technique that uses the quoted price of the identical liability or similar liabilities when traded as an asset, which would be considered a Level 1 input, or another valuation technique that is consistent with ASC 820. This Update is effective for the first reporting period (including interim periods) beginning after issuance. Thus, we adopted this guidance as of September 30, 2009, which did not have a material impact on our consolidated financial statements.

(2) INVESTMENT IN BRITWATER INTERNATIONAL, LLC.

In June 2009, we acquired an interest in a privately-held company, BWI, with a patented oilfield emulsion breaking OHSOL technology by entering into a Securities Exchange Agreement (the Agreement) pursuant to which we issued an aggregate of 1 million restricted shares of our common stock in exchange for 1,950 units of BWI, which constitutes 19.5% of BWI's outstanding membership units. The shares are deemed to be restricted because they were not issued in a transaction registered under the Securities Act of 1933 and are therefore not freely transferable. Pursuant to the terms of our investment, HKN and the other BWI unitholders have granted to one another put and call options with respect to an additional 3,050 units of BWI in exchange for an additional issuance of 725 thousand restricted shares of our common stock. These options are exercisable only if the following conditions are satisfied prior to June 2012:

The Call Option may be exercised upon the occurrence of any of the following events:

- Execution by BWI of a material contract regarding any of the BWI patented technologies
- BWI achieves positive Operating Margins during two consecutive quarters

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- BWI achieves positive Net Income during two consecutive quarters
- BWI receives a qualified offer to sell substantially all of its assets or to merge with another entity and BWI declines such offer
- A Change of Control occurs at BWI
- The average closing price of HKN common stock is above \$3.50 for any consecutive 30 day trading period

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- Any BWI transaction that dilutes HKN's ownership of BWI by more than 10%
- BWI consummates a securities offering under the 1933 Act that results in aggregate net cash proceeds to BWI of at least \$10 million

The Put Option may be exercised upon the occurrence of any of these events:

- BWI incurs net losses for any four consecutive quarters
- A Change of Control occurs at HKN
- The average closing price of HKN common stock is below \$1.50 per share or above \$4.00 per share for any consecutive 30 day trading period

In June 2009, we entered into a Loan Agreement with BWI under which we may make secured loans to BWI up to a maximum amount of \$2.5 million. These loans are secured by all assets of BWI and are due and payable on or before June 30, 2012. As of December 31, 2009, we have made approximately \$1 million in aggregate secured loans to BWI. The Loan Agreement earns interest at 8.0% per annum. Accrued and unpaid interest on the outstanding principal amount of the Loan shall be due and payable on the last day of each calendar quarter. BWI shall repay the entire unpaid principal amount of the loan, together with all accrued and unpaid interest, on or before June 30, 2012.

The assets, liabilities and non-controlling interest associated with our investment were consolidated into our financial statements per ASC 810-10, *Consolidation*, using the acquisition method of accounting in accordance with ASC 805, *Business Combinations*. See Note 1 Summary of Significant Accounting Policies for further explanation for consolidating our investment in BWI. Our acquisition-related costs of approximately \$87 thousand are included in general and administrative expenses within our consolidated statement of operations for the year ended December 31, 2009.

Valuation of Investment in BWI The fair value of the total consideration paid for our investment which includes 1.0 million restricted shares of common stock issued along with the put/call option to issue 725 thousand restricted shares of our common stock was measured using a third-party Fair Market Value Restricted Stock Study, which valued the aggregate restricted shares at the investment date at \$2.01 per share. Under the ASC 820, *Fair Value Measurements and Disclosures*, we consider this valuation method for our restricted stock to be a Level 2 classification. See Note 6 Fair Value Measurements for further discussion of Level 2 valuation definitions. This valuation considered several factors, including the closing market price of our common stock at the acquisition date of \$2.55 per share and the diminished marketability caused by the restrictive nature of the shares issued. We applied the discounted value of \$2.01 per share to the total of the 1.0 million restricted shares transferred and the potential 725 thousand restricted shares to be issued upon the exercise of the put or call options in order to calculate the fair value of our interest in the net assets acquired.

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The following table is the preliminary calculation of the consideration paid for our initial 19.5% ownership in the BWI investment, the allocation to assets and liabilities assumed and the fair value of the noncontrolling interest in BWI as of the investment date. This purchase price allocation as of December 31, 2009 is subject to adjustment, pending the final valuation of the fair value of certain assets acquired and liabilities assumed.

(in thousands, except share amounts)

Consideration issued to BWI:	
1.0 million shares of restricted common stock	\$ 1,352
Fair value of total consideration transferred	\$ 1,352
Recognized amounts of identifiable assets acquired and liabilities assumed, at estimated fair values	
Cash and cash equivalents	\$ 7
Equipment	6,900
Intangible assets	1,946
Accounts payable	(380)
Accrued liabilities	(10)
Deferred income taxes	(729)
Contingent liability	(800)
Total identifiable net assets	\$ 6,934
Noncontrolling interest (80.5 %)	(5,582)
Fair value of our interest in net assets acquired (19.5 %)	\$ 1,352

The intangible assets consist of patents related to the OHSOL process. The fair value of the acquired patents of \$1.9 million was estimated based on the historical cost of the patents; the final valuation is pending a third party valuation in 2010. Unless renewed, the patents will expire during the next 6-12 years. The fair value of the OHSOL plant equipment of \$6.9 million was estimated as the replacement cost of the equipment. The valuation of the equipment is also pending a third party valuation to be completed in 2010. We consider these valuations for our patents and equipment to be Level 3 classifications. See Note 6 Fair Value Measurements for further discussion of Level 3 valuation definitions. The contingent liability of \$800 thousand may be payable to a vendor upon the conclusion of certain testing events of the OHSOL plant equipment. This contingent liability is included in other accrued liabilities within the consolidated balance sheet.

A deferred tax liability in the amount of \$729 thousand was calculated by applying the domestic statutory tax rates to the difference between the book purchase price and the estimated tax basis. Information and research regarding the tax basis of the assets at the date of the acquisition is not complete at this time and the deferred tax may be adjusted as more information becomes available.

BWI Results of Operations For the year ended December 31, 2009, we recognized losses of \$387 thousand related to our investment in BWI in our consolidated statement of operations, of which \$295 thousand was related to noncontrolling interests. We do not consider BWI's pre-acquisition activity to significantly impact our proforma results of operations.

(3) OTHER INVESTMENTS

Marketable Securities We held no marketable securities at December 31, 2009. Our marketable securities at December 31, 2008 consisted of \$9.5 million in Treasury bills with original maturities of six months. These investments were recorded at their fair value at the balance sheet date. There were no significant gains or losses on these securities for any period covered by this report.

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Investment in Global As we do not have the ability to obtain Global's US GAAP adjusted financial information, we account for our investment in Global's shares as an available-for-sale cost method investment. Investments in equity securities that do not qualify as trading investments and are not likely to be sold within a year are classified as non-current available-for-sale investments. Our non-current available-for-sale investment consists of our ownership of approximately 34% of Global's outstanding ordinary shares. At December 31, 2009 and December 31, 2008, our investment in Global was equal to the market value of our 11.9 million shares of Global's ordinary shares as follows (in thousands, except share amounts):

	December 31, 2009		December 31, 2008	
Shares of Global Stock held by HKN		11,893,463		11,893,463
Closing price of Global Stock	£	0.66	£	0.68
Foreign Currency Exchange Rate		1.6221		1.4619
Market Value of Investment in Global	\$	12,637	\$	11,824

The foreign currency translation adjustment of approximately \$789 thousand and the unrealized gain on investment of \$24 thousand for these changes in market value between the two periods were recorded to other comprehensive income in stockholders' equity during the year ending December 31, 2009.

(4) EQUITY INVESTMENT IN SPITFIRE ENERGY

At December 31, 2009 and 2008, we held an investment in Spitfire through the ownership of approximately 25% and 27%, respectively, of Spitfire's currently outstanding common shares. Spitfire is an independent public company (TSX-V; SEL) engaged in the exploration, development and production of crude oil, natural gas and natural gas liquids in Western Canada.

At December 31, 2009, we owned 9.9 million common shares of Spitfire and 1.3 million warrants to acquire common shares of Spitfire. As a result of our ownership of Spitfire's outstanding common shares, we are deemed to have the ability to exert significant influence over Spitfire's operating and financial policies. Accordingly, we reflect our investment in Spitfire as an equity method investment. Due to timing differences in our filing requirements and the lack of availability of financial information for the current quarterly period, we record our share of Spitfire's financial activity on a three-month lag.

During the 2009, we sold approximately 1.2 million shares of Spitfire common shares for \$212 thousand using the average cost method. We recognized a foreign currency gain of \$6 thousand in other comprehensive income and a realized gain on sale of assets of \$30 thousand which is included in other income in the consolidated statement of operations.

During 2008, we purchased shares of Spitfire common stock in the market by acquiring 236 thousand shares at a total cost of \$77 thousand. We reflected our additional purchases of shares in Spitfire as a step acquisition of an equity method investment. No goodwill was recorded as a result of these purchases. Also during 2008, Spitfire's share price declined significantly and we recorded an impairment charge of \$4.6 million to write down the carrying value of our investment to its market value of \$1.8 million as of December 31, 2008. In 2009, there were no other impairments to this investment. However, further declines in Spitfire's share price and the Canadian stock markets in the future may require additional impairment of our investment in Spitfire if these declines are deemed to be other-than-temporary.

In accordance with the equity method of accounting, our investment was initially recorded at cost and adjusted to reflect our share of changes in Spitfire's capital. It has been subsequently adjusted to recognize our share of their earnings as they occur, rather than as dividends or other distributions are received. Our share of

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their earnings also includes any other-than-temporary declines in fair value recognized during the period. On January 1, 2009, we adopted guidance under ASC 323-10-35, *Investments- Equity Method and Joint Ventures*. As a result, changes in our proportionate share of the underlying equity of Spitfire which result from their issuance of additional equity securities are also recognized in our share of their earnings in our results of operations.

Our investment in Spitfire is reported in our balance sheet at its adjusted carrying value as a non-current asset, and our earnings are reported net of tax as a single line on our income statement. At December 31, 2009 and 2008, our carrying value of this investment was \$1.6 million and \$1.8 million, respectively.

(5) DERIVATIVE INSTRUMENTS

Trading Derivatives- As part of our treasury activities during 2008 and 2007, we engaged in the active management of investments and derivative instruments in energy industry securities traded on domestic securities exchanges. We used these derivatives as a tool to enhance investment returns or to minimize the risk in our energy industry portfolio. These derivatives were not designated as hedges under ASC 815, and we recognized gains and losses related to these positions in current earnings.

We currently do not hold any open trading derivative positions as of December 31, 2009. During 2008, we closed all of our open trading derivative positions. For the year ended December 31, 2008 we recognized realized losses of \$2.7 million related to these derivatives within trading revenues in our consolidated statement of operations. For the year ended December 31, 2007 we included unrealized gains of \$18 thousand and realized gains of \$935 thousand related to these derivatives within trading revenues in our consolidated statement of operations.

Commodity Derivatives - We enter into certain commodity derivative instruments which are effective in mitigating commodity price risk associated with a portion of our future monthly natural gas and crude oil production and related cash flows. Our oil and gas operating revenues and cash flows are impacted by changes in commodity product prices, which are volatile and cannot be accurately predicted. Our objective for holding these commodity derivatives is to protect the operating revenues and cash flows related to a portion of our future crude oil sales from the risk of significant declines in commodity prices. We have not designated any of our commodity derivatives as hedges under ASC 815.

In December 2009, we purchased crude oil commodity floor contracts for \$30 thousand. Our purchased commodity derivatives are recorded at their estimated fair values within other current assets in the accompanying consolidated balance sheets. Estimated fair values of our purchased commodity derivatives were as follows (in thousands):

Commodity	Type	Volume/Day	Duration	Price	As of December 31,		
					2009	2008	2007
Crude Oil	Floor	9,000 bbls	Feb 08 - Mar 08	\$ 80.00	\$	\$	3
Crude Oil	Floor	5,000 bbls	Jan 10 - May 10	\$ 60.00	15	\$	3
					\$ 15	\$	3

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We have recorded net losses related to crude oil and natural gas derivative transactions for the years ended December 31, 2009, 2008 and 2007 of \$16 thousand, \$1.2 million and \$182 thousand. These amounts are included in other losses for 2009 and trading losses in 2008 and 2007 in our consolidated statement of operations.

As of December 31, 2009, neither we nor any of our consolidated companies hold any derivative instruments which are designated as fair value hedges, cash flow hedges or foreign currency hedges. Settlements of our oil and gas commodity derivatives are based on the difference between fixed option prices and the New York Mercantile Exchange closing prices for each month during the life of the contracts. We

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monitor our crude oil and natural gas production prices compared to New York Mercantile Exchange prices to assure our commodity derivatives are effective in mitigating our commodity price risk.

Foreign Currency Derivative Contracts - During 2008, we entered into certain foreign currency derivative instruments to mitigate the foreign currency price risk associated with our investment in Global's ordinary shares. Our investment in Global is impacted by changes in the British Sterling Pound exchange rate to U.S. dollars. We did not designate any of our foreign currency derivatives as hedges under ASC 815. During 2008, we closed all of our open foreign currency derivatives and we realized gains of \$97 thousand in trading revenues in our consolidated statement of operations. We did not hold any foreign currency derivative contracts in 2009.

We had no trading revenues for the year ended December 31, 2009. For years ended December 31, 2008 and 2007, we have included the following unrealized and realized gains and losses related to our trading derivatives within trading revenues in our consolidated statement of operations (in thousands):

Type of Instrument	For the Year Ended	
	December 31, 2008	December 31, 2007
Commodity	\$ 39	\$ (183)
Equity	(3,251)	863
Crude Futures	(1,229)	
Foreign Currency	97	
Total trading (loss) revenue	\$ (4,344)	\$ 680

Spitfire Warrants - In association with our investment in Spitfire, we also hold 1.3 million warrants to acquire common shares of Spitfire. We account for these warrants as derivatives in accordance with ASC 815. The expiration date of the warrants is August 1, 2010. At December 31, 2008, we reflected these warrants at their estimated fair value of \$16 thousand in our balance sheet and included losses of \$96 thousand within interest expense and other losses in our consolidated statement of operations for the year ended December 31, 2008. We did not assign any value to these warrants at December 31, 2009. For the year ended December 31, 2009, we have included unrealized losses of \$16 thousand within other losses in our consolidated statement of operations. These amounts are related primarily to the change in the underlying price of Spitfire's common shares.

Series M Preferred Conversion Feature - Prior to its redemption during 2009, our Series M Convertible Preferred Stock (Series M Preferred) was convertible at the holders' option into common stock at a conversion price of \$11.85 per share. This conversion price was subject to continued adjustment in the event we subsequently issued shares of our common stock at a price lower than this conversion price or in response to certain transactions that are in effect equity restructuring transactions. Under ASC 815-40-15, this anti-dilution provision allowing for the conversion price to be adjusted represented an embedded derivative that required it to be classified as a liability. We would only incur the liability, equal to the current stock price times the number of additional shares that would be required to fulfill the conversion, if we were to issue common stock at a price less than the Series M Preferred conversion price. At January 1, 2009, we recorded a Series M Preferred conversion liability with an initial estimated fair value of \$5 thousand as a cumulative effect adjustment. As further described in Note 11 Stockholders' Equity, we fully redeemed all of the outstanding Series M Preferred in 2009, therefore there is no Series M Preferred conversion liability at December 31, 2009. In 2009, we have included unrealized gains of \$5 thousand within other gains in our consolidated statement of operations related primarily to extinguishment of this liability.

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We did not hold any derivative instruments designated as hedging instruments under ASC 815 as of December 31, 2009. A summary of the fair values of our derivative instruments not designated as hedging instruments under ASC 815 as of December 31, 2009 and 2008 are as follows (in thousands):

Asset Derivatives	Balance Sheet Location	Fair Value	
		Year Ended December 31, 2009	Year Ended December 31, 2008
Spitfire warrants	Other assets	\$	\$ 16
Commodity contracts	Other assets		15
Total derivatives		\$	\$ 15

Any gains or losses related to our derivative instruments are included in the consolidated statement of operations for the years ended December 31, 2009, 2008 and 2007 as follows (in thousands):

Derivatives	Location of Loss or (Gain) Recognized in Income on Derivatives	Amount of Loss or (Gain) Recognized in Income on Derivatives		
		Year Ended December 31, 2009	Year Ended December 31, 2008	Year Ended December 31, 2007
Spitfire warrants	Other losses	\$ 16	\$ 96	\$ 353
Commodity contracts	Other losses	16		
Series M Preferred conversion feature	Other income	(5)		
		\$ 27	\$ 96	\$ 353

(6) FAIR VALUE MEASUREMENTS

Beginning January 1, 2009, we applied ASC 820, *Fair Value Measurements and Disclosures*, to nonrecurring, nonfinancial assets and liabilities, which were previously deferred by the FASB. We applied this guidance to our financial assets and liabilities beginning January 1, 2009 with no material impact on our consolidated statement of operations or financial condition.

ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 also establishes a framework for measuring fair value and a valuation hierarchy based upon the transparency of inputs used in the valuation of an asset or liability. Classification within the hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The valuation hierarchy contains three levels:

- Level 1 Valuation inputs are unadjusted quoted market prices for identical assets or liabilities in active markets.

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- Level 2 Valuation inputs are quoted prices for identical assets or liabilities in markets that are not active, quoted market prices for similar assets and liabilities in active markets and other observable inputs directly or indirectly related to the asset or liability being measured.

- Level 3 Valuation inputs are unobservable and significant to the fair value measurement.

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We used the following fair value measurements for certain of our assets and liabilities during the year ended December 31, 2009:

Level 1 Classification:

Investment in Global Global's ordinary shares are publicly traded on the Alternative Investment Market (AIM) of the London Stock Exchange with quoted prices in active markets. Accordingly, the fair value measurements of these securities have been classified as Level 1.

Commodity contracts Our purchased commodity derivatives have quoted prices in active markets. Accordingly, the fair value measurements of these securities have been classified as Level 1.

Level 2 Classification:

Valuation of Our Restricted Stock Utilized as Consideration for our Investment in BWI Our BWI purchase price allocation utilized fair values under ASC 805, *Business Combinations*, on a nonrecurring basis. Please see Note 2 Investment in BriteWater International, LLC. for further discussion on the valuation of this investment.

Level 3 Classification:

Asset Retirement Obligations Our asset retirement obligation is classified as a Level 3 liability. The significant unobservable inputs to this fair value measurement include estimates of plugging, abandonment and remediation costs, inflation rate and the expected remaining life of wells. The inputs are calculated utilizing historical data, current estimated costs and expectations for the future costs and production of the wells. See Note 9 Asset Retirement Obligations for additional information of our asset retirement obligation as of December 31, 2009.

Valuation of BWI Equipment and Patents The fair value of the acquired patents of \$1.9 million is non-recurring and was estimated based on the historical cost of the patents; the final valuation is pending a third party valuation in 2010. Unless renewed, the patents will expire during the next 6-12 years. The fair value of the OHSOL plant equipment of \$6.9 million is also non-recurring and was estimated as the replacement cost of the equipment. The valuation of the equipment is also pending a third party valuation to be completed in 2010. We consider these valuations for the OHSOL patents and equipment to be Level 3 classifications.

The following table presents recurring financial assets and liabilities which are carried at fair value as of December 31, 2009 (in thousands):

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	Level 1	Level 2	Level 3
Investment in Global (cost method)	\$ 12,637	\$	\$
Commodity contracts	15		
Total assets at fair value	\$ 12,652	\$	\$

	Level 1	Level 2	Level 3
Asset retirement obligation	\$	\$	\$ 6,193
Total liabilities at fair value	\$	\$	\$ 6,193

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The table above does not include our equity investment in Spitfire because we are deemed to have a significant influence and, as such, the investment is not accounted for at fair value under ASC 820, *Fair Value Measurements and Disclosures*, at December 31, 2009.

The reconciliation of the fair value for our Level 3 assets and liabilities (the Spitfire warrants and Series M Preferred conversion feature), including net purchases and sales, realized gains and change in unrealized gains, is set out below (in thousands):

	For the Year Ended December 31, 2009	
	Level 3 Asset	Level 3 Liability
	Spitfire Warrants	Series M Preferred Conversion Feature
Beginning balance	\$ 16	\$ 5
Total realized and unrealized losses included in earnings	(16)	(5)
Net purchases and sales		
Ending balance	\$	\$

(7) OIL AND GAS PROPERTIES

Under full cost method of accounting, we assess realizability of unevaluated properties on at least an annual basis or when there has been an indication that an impairment in value may have occurred, such as for a relinquishment of contract acreage. Impairment of unevaluated prospects is assessed based on management's intention with regard to future exploration and development of individually significant properties and the ability to obtain funds to finance such exploration and development. At December 31, 2009, we carried total costs of \$5.1 million related to the exploration and development of our coalbed methane prospects within the Indiana Posey area in our unevaluated oil and gas properties. We anticipate our unevaluated property costs to remain as unevaluated for no longer than three years.

Under full cost accounting rules for each cost center, capitalized costs of evaluated oil and gas properties, including asset retirement costs, less accumulated amortization and related deferred income taxes, may not exceed an amount (the cost ceiling) equal to the sum of (a) the present value of future net cash flows from estimated production of proved oil and gas reserves, based on current economic and operating conditions, discounted at 10%, plus (b) the cost of properties not being amortized, plus (c) the lower of cost or estimated fair value of any unproved properties included in the costs being amortized, less (d) any income tax effects related to differences between the book and tax basis of the properties involved. If capitalized costs exceed this limit, the excess is charged to earnings.

For purposes of the ceiling test, we remove the discounted present value included in our future development costs on our reserve report for which we have already booked an obligation under ASC 410-20, *Asset Retirement Obligations*. For purposes of our depletion calculation, we include in future development costs any estimated plugging and abandonment costs, net of estimated salvage values, for proved undeveloped wells. For purposes of both of these calculations, we do not include plugging and abandonment costs in our future development costs on developed properties for which we have booked an obligation under ASC 410-20.

As a result of low oil and gas prices in the fourth quarter of 2008, our capitalized costs of evaluated oil and gas properties exceeded the cost ceiling, and we recorded an impairment of \$19.9 million to our oil and gas properties for the year ended December 31, 2008. No such impairment was recorded for the year ended December 31, 2009.

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(8) UNEVALUATED PROPERTIES - COALBED METHANE PROJECT

Indiana Posey - In 2005 we entered into an exploration and development agreement (the *Indiana Posey Agreement*) with Indiana Posey L.P., a Texas limited partnership, for the joint exploration and development of coalbed methane within the Posey Prospect area consisting of approximately 400,000 acres in Posey, Gibson and Vanderburgh counties of Indiana.

The Indiana Posey Agreement provides for the project to be conducted in three separate phases. Our potential obligations under the Indiana Posey Agreement, if we elect to all phases of the project, include funding 100% of the initial \$7.5 million in costs to carry out the joint exploration and development of the project in return for a non-operating 65% interest in the Posey Prospect Area. The Indiana Posey Agreement also provides that we are to receive an 82.5% net revenue interest. At December 31, 2009, we carried total costs of \$5.1 million related to the exploration and development of our coalbed methane prospects within the Indiana Posey area in our unevaluated oil and gas properties.

Ohio Cumberland - In 2005, we entered into an exploration and development agreement (the *Ohio Cumberland Agreement*) with Ohio Cumberland, L.P., a Texas limited partnership, for the joint exploration and development of coalbed methane within the Cumberland Prospect Area consisting of approximately 400,000 acres in Guernsey, Noble, Muskingum, Washington and Morgan Counties of Ohio.

The Ohio Cumberland Agreement had an effective date of April 1, 2005 and provides for the project to be conducted in three separate phases. Our potential obligations under the Ohio Cumberland Agreement, if we elect to all phases of the project, include funding 100% of the initial \$7.5 million in costs to carry out the joint exploration and development of the project in return for a non-operating 65% interest in the Cumberland Prospect Area. The Ohio Cumberland Agreement also provides that we are to receive a 82.5% net revenue interest. This Phase II project has been temporarily suspended until such time as oil and gas commodity pricing increases. All costs associated with the Ohio Cumberland Agreement, approximately \$1.6 million, were reclassified to evaluated oil and gas properties in 2008. At this time, we are focusing our efforts on the Indiana Posey Contract.

With the decline in oil and gas commodity prices, resource plays, such as coalbed methane prospects, can become uneconomical in low price environments particularly since all well, facility and flowline costs as well as operating costs during the dewatering/desorption process must be incurred before revenues can be generated. Our discretionary capital expenditures, including costs related to our coalbed methane prospects, may be curtailed at our discretion in the future. Such expenditure curtailments could result in us losing certain prospect acreage or reducing our interest in future development projects.

(9) ASSET RETIREMENT OBLIGATIONS

We recognize the present value of asset retirement obligations beginning in the period in which they are incurred if a reasonable estimate of a fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. A summary of our assets with required asset retirement obligations as of December 31, 2009 is as follows (in thousands):

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Asset Category	Asset Retirement Obligation Liability	Estimated Life
Oil and gas producing properties	\$ 4,648	1-18 years
Facilities and other property	1,545	3-25 years
	\$ 6,193	

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The following table describes all changes to our asset retirement obligation liability during the years ended December 31, 2009 and 2008 (in thousands):

	2009	2008
Asset retirement obligation at beginning of year	\$ 5,472	\$ 5,187
Additions during the year	60	45
Disposals during the year	(9)	(123)
Revisions of estimates	278	
Accretion expense	392	363
Asset retirement obligation at end of year	\$ 6,193	\$ 5,472

During 2009, we revised our asset retirement obligation estimates mainly due to increases in the expected costs related to our wells and facilities. We had no revisions during 2008.

(10) INCOME TAXES

The total provision for income taxes consists of the following:

	2009	Year Ended December 31, 2008 (in thousands)	2007
Current Taxes:			
Federal	\$	\$ 260	\$
State	(40)	15	10
Foreign			
Deferred:			
Federal			
State			20
Total	\$ (40)	\$ 275	\$ 30

The following is a reconciliation of the reported amount of income tax expense (benefit) for the years ended December 31, 2009, 2008 and 2007 to the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income:

	2009	Year Ended December 31, 2008 (in thousands)	2007
Statutory tax expense (benefit)	\$ (1,037)	\$ (9,000)	\$ 1,108
Increase (decrease) in valuation allowances related to:			
Capital losses		1,763	

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Net operating losses	1,037	7,229	(1,111)
Alternative minimum tax		35	
Other		8	3
FIN 48 accrual		225	
State Tax	(40)	15	30
Total tax expense (benefit)	\$ (40)	\$ 275	\$ 30

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At December 31, 2009, we had available for U.S. federal income tax reporting purposes, a net operating loss (NOL) carryforward for regular tax purposes of approximately \$96 million which expires in varying amounts during the tax years 2010 through 2029, an alternative minimum tax NOL carryforward of approximately \$80 million which expires in varying amounts during the tax years 2010 through 2029, and a statutory depletion carryforward of approximately \$9 million which can be carried forward indefinitely to offset our future taxable income, subject to certain limitations imposed by the Internal Revenue Code. Additionally, at December 31, 2009, we have a capital loss carryforward of approximately \$91 million which will expire in 2010 and 2014. Current federal income tax law allows corporations to deduct capital losses only if they offset capital gains. In 2003, we underwent a change in ownership, within the meaning of Internal Revenue Code Section 382 that will significantly restrict our ability to utilize our domestic NOLs and capital losses.

In June 2009, we acquired a 19.5% interest in BWI and as a result, we consolidated BWI in our consolidated financial statements per ASC 805, *Business Combinations*. Pursuant to our investment in BWI, a deferred tax liability in the amount of \$729 thousand was calculated by applying the domestic statutory tax rates to the difference between the book purchase price and the estimated tax basis. Information and research regarding the tax basis of the assets at the date of the acquisition is not complete at this time and the deferred tax may be adjusted as more information becomes available.

The components of our income taxes were as follows for the years ended December 31, 2009 and 2008:

	2009		2008
	(in thousands)		
Deferred tax assets:			
Net operating losses (NOL) carryover	\$	32,633	\$ 32,318
Depletion carryover		3,128	3,094
Deferred book liabilities		2,106	1,860
Book vs. tax basis in investments		23,855	24,235
Capital loss carryover		30,940	35,835
Property and equipment			1,272
Total gross deferred tax assets		92,662	98,614
Deferred tax liabilities:			
Property and equipment		(1,049)	
Net deferred tax assets		91,613	98,614
Less valuation allowances		(92,361)	(98,634)
Deferred tax liabilities, net of valuation allowance	\$	(748)	\$ (20)

Our policy is to recognize potential interest and penalties accrued related to unrecognized tax benefits within income tax expense. The tax years 2005-2008 remain open to examination for federal income tax purposes and by the other major taxing jurisdictions to which we are subject. The tax years 2005-2009 also remain open for examination purposes for the Texas Franchise tax.

In May 2006, the Governor of Texas signed into law a Texas margin tax (H.B. No. 3) which restructured the state business tax by replacing the taxable capital and earned surplus components of the current franchise tax with a new taxable margin component. Specifically, we became subject to an entity level tax on the portion of our total revenue (as that term is defined in the legislation) that is generated in Texas beginning in our tax year ending December 31, 2007. Specifically, the Texas margin tax is imposed at a maximum effective rate of 0.7% of our total revenue that is apportioned to Texas. We recorded a deferred tax

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liability in 2007 related to the Texas Margin Tax of \$20 thousand. There have been no changes to the Texas Margin Tax in 2008 or 2009.

During 2008, we received a proposed adjustment to our federal tax liability for the calendar year 2005. The proposed adjustment relates to the calculation of the adjusted current earnings (ACE) component of the alternative minimum tax and asserts that the Company recognized a gain for ACE purposes on the sale of the Global PLC stock in 2005. In its proposed adjustment, the IRS alleges that the Company owes approximately \$3.6 million in tax for the year ended December 31, 2005. Penalties and interest calculated through December 31, 2010 in the amount of \$2.4 million could also be assessed. We filed a formal protest with the IRS Appeals Office during 2008. In April 2009, we filed our supplement to the written protest which included a third party valuation report supporting the basis of our recognized gain recorded for ACE purposes. Based on correspondence received to date, the IRS Appeals Office is still considering the matter.

ASC 740, *Income Taxes*, prescribes a recognition threshold of more-likely-than-not to be sustained upon examination. This guidance also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosures and transition. Utilizing the process outlined above, we have recorded an income tax contingency for this item, including interest and penalties, of \$225 thousand in our consolidated financial statements based, in part, on a preliminary indication of a probability-weighted fair value assessment of the Global stock. Although we intend to vigorously defend the proposed adjustment and strongly believe the third party valuation report supports our position and that we have meritorious defenses, if the IRS Appeals Office were to deny all of our protests and our assumptions and estimates associated with this income tax contingency are inaccurate, we could be liable for approximately \$5.7 million in additional tax, penalties and interest. In March 2010, the IRS requested and we agreed to extend the statute of limitations to June 2011. We anticipate the appeals office will contact us to address this matter but have received no additional response to date.

The following table illustrates changes in our gross unrecognized tax benefits (in thousands) for the years ending December 31, 2009 and 2008. We had no unrecognized tax benefits during 2007.

	2009		2008	
Unrecognized tax benefits at January 1,	\$	225	\$	
Increases for positions taken in current year				225
Decreases for positions taken in current year				
Decreases for settlements with taxing authorities				
Decreases for lapses in the applicable statute of limitations				
Unrecognized tax benefits at December 31,	\$	225	\$	225

(11) STOCKHOLDERS EQUITY

Common Stock We have authorized 24 million shares of \$.01 par common stock. At December 31, 2009 and 2008, we had 9,553,847 and 9,268,253 shares, respectively, issued and outstanding. Dividends may not be paid to holders of our common stock prior to the satisfaction of all dividend obligations related to our Series G1 and Series G2 Preferred stock.

Treasury Stock In 2005, our Board of Directors authorized a stock repurchase program allowing us to buy back a total of 1.2 million shares of our common stock (adjusted for the 2007 reverse stock split). During 2008, we repurchased 507 thousand shares of our common stock in the open market at a cost of approximately \$4.4 million pursuant to our repurchase program. In 2008, we cancelled 500 thousand of these shares. At

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December 31, 2008, we held 6,869 shares of treasury stock, and approximately 237 thousand shares remained available for repurchase under our repurchase program.

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In January 2009, our Board of Directors authorized an amendment to the existing repurchase plan allowing us to repurchase an additional 1.0 million shares of our common stock. During 2009, we repurchased approximately 708 thousand shares of our common stock. This included a repurchase of 500 thousand shares of our common stock for \$1.3 million from a shareholder in a privately negotiated transaction pursuant to our repurchase program. During the year ended December 31, 2009, we retired approximately 715 thousand treasury shares. As of December 31, 2009 approximately 530 thousand shares remained available for repurchase under our repurchase program.

Series G1 Convertible Preferred Stock - Our Series G1 Convertible Preferred Stock (the Series G1 Preferred), which was issued in 2000, has a liquidation value of \$100 per share, is non-voting, and is convertible at the holder's option into our common stock at a conversion price of \$280.00 per share. At December 31, 2009 and 2008, there were 1,000 shares and 1,600 shares, respectively, of Series G1 Preferred issued and outstanding.

The Series G1 Preferred holders shall be entitled to receive dividends at an annual rate equal to \$8.00 per share when, as and if declared by our Board of Directors. All dividends on the Series G1 Preferred are cumulative and payable semi-annually in arrears on June 30 and December 30. At our option, dividends may also be payable in our common stock valued at \$280.00 per share. The Series G1 Preferred dividend and liquidation rights shall rank junior to all claims of creditors, but senior to our common stockholders and to any subsequent series of our preferred stock, unless otherwise provided, except for the Series G2 Preferred, which shall rank equal to the Series G1 Preferred.

Redemption of Series G1 Preferred - During 2009, we redeemed six hundred shares of our Series G1 Preferred with a liquidation value of \$100 per share for \$5 thousand in cash. In addition, we paid approximately \$2 thousand in accrued dividends on these shares.

Series G2 Convertible Preferred Stock - Our Series G2 Preferred Stock (Series G2 Preferred), which was issued in 2000, has a liquidation value of \$100 per share, is non-voting, and is convertible at the holder's option into our common stock at a conversion price of \$67.20 per share. The Series G2 Preferred is also convertible by us into shares of our common stock if for any period of twenty consecutive calendar days the average of the closing prices of our common stock during such period shall have equaled or exceeded \$84.00 per share. At December 31, 2009 and 2008, there were 1,000 shares of Series G2 Preferred issued and outstanding.

The Series G2 Preferred holders shall be entitled to receive dividends at an annual rate equal to \$8.00 per share when, as and if declared by our Board of Directors. All dividends on the Series G2 Preferred are cumulative and payable semi-annually in arrears on June 30 and December 30. At our option, dividends may also be payable in our common stock at \$67.20 per share of our common stock. The Series G2 Preferred dividend and liquidation rights shall rank junior to all claims of creditors but senior to our common stockholders and to any subsequent series of our preferred stock, unless otherwise provided. The Series G2 Preferred shall rank equal to the Series G1 Preferred.

Series M Preferred - Our Series M Preferred, which was issued in 2004, had a liquidation value of \$100 per share, was non-voting and was convertible at the holders' option into common stock at a conversion price of \$13.44 per share which was later adjusted to \$13.22. This conversion price was subject to continued adjustment in the event we subsequently issued shares of our common stock at a price lower than this conversion price or in response to certain transactions that are in effect equity restructuring transactions. During 2009, we paid \$260 thousand in preferred dividends, of which \$124 thousand was paid in connection with the redemption of the 44,000 shares of Series M Preferred during 2009. During 2008, we paid \$284 thousand in preferred dividends.

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Change in the Conversion Price of the Series M Preferred In June 2009 upon the issuance of our shares for our investment in BWI, the conversion price of the Series M Preferred decreased from \$13.22 to \$11.85 per share. The incremental intrinsic value of the change in the Series M Preferred conversion price of \$76 thousand is reflected as a payment of preferred stock dividends in our consolidated statement of operations during the year ended December 31, 2009.

Redemption of Series M Preferred During 2009, we redeemed all 44 thousand shares of our Series M Preferred with a liquidation value of \$100 per share for \$4.4 million in cash. In addition, we paid approximately \$124 thousand in accrued dividends on these shares.

The number of common and preferred shares outstanding and shares held in treasury during 2009 and 2008 are as follows:

Description	Number of Shares				
	Preferred G1	Preferred G2	Preferred M	Common	Treasury
Balance as of December 31, 2007	1,600	1,000	44,000	9,768,261	
Issuances of preferred stock dividends				249	
Treasury Stock repurchase					507,126
Treasury Stock cancellation				(500,257)	(500,257)
Balance as of December 31, 2008	1,600	1,000	44,000	9,268,253	6,869
Issuances of preferred stock dividends				157	
Preferred stock redemption	(600)		(44,000)		
Issuance of restricted shares for investment				1,000,000	
Treasury Stock repurchase					707,694
Treasury Stock cancellation				(714,563)	(714,563)
Balance as of December 31, 2009	1,000	1,000		9,553,847	

Noncontrolling Interest In June 2009, we recorded \$5.6 million attributable to noncontrolling interests in our consolidated balance sheet which represents the fair value of the other BWI unitholders' 80.5% interest in the net assets of our investment in BWI. During year ended December 31, 2009, we recorded losses of \$295 thousand related to the results of operations of BWI to noncontrolling interest which resulted in a noncontrolling interest of \$5.3 million at December 31, 2009. Please see Note 2 Investment in BriteWater International, LLC. for additional information of our investment in BWI.

Put/Call Option to Issue Common Shares Pursuant to the terms of our investment in BWI and the related agreement, HKN and the other BWI unitholders have granted to one another put and call options with respect to 3,050 units of BWI in exchange for issuance of 725 thousand restricted shares of our common stock. These options are exercisable only if certain conditions are satisfied prior to June 2012. None of these conditions have been met as of December 31, 2009.

At December 31, 2009, if our remaining convertible preferred stock was converted and the put/call option was exercised, we would be required to issue the following amounts of common stock:

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Instrument		Conversion Price (a)	Shares of Common Stock Issuable at December 31, 2009
Series G1 Preferred	\$	280.00	357
BWI Put/Call Option			725,000
Series G2 Preferred	\$	67.20	1,488
Common Stock Potentially Issued Upon Conversion			726,845

(a) Certain conversion prices are subject to adjustment under certain circumstances.

Stockholder Rights Plan In April 1998, we adopted a rights agreement (the *Rights Agreement*) whereby a dividend of one preferred share purchase right (a *Right*) was paid for each outstanding share of our common stock. The Rights will be exercisable only if a person acquires beneficial ownership of 15% or more of our common stock (an *Acquiring Person*), or commences a tender offer which would result in beneficial ownership of 15% or more of such stock. When they become exercisable, each Right entitles the registered holder to purchase from us one one-thousandth of one share of Series E Junior Participating Preferred Stock (*Series E Preferred Stock*), at a price of \$35.00 per one one-thousandth of a share of Series E Preferred Stock, subject to adjustment under certain circumstances. During 2002, our Board of Directors amended the Rights Agreement to exclude from the definition of an *Acquiring Person* certain parties who have received or would receive beneficial ownership pursuant to certain transactions.

Upon the occurrence of certain events specified in the Rights Agreement, each holder of a Right (other than an *Acquiring Person*) will have the right to purchase, at the Right's then current exercise price, shares of our common stock having a value of twice the Right's exercise price. In addition, if, after a person becomes an *Acquiring Person*, we are involved in a merger or other business combination transaction with another person in which we are not the surviving corporation, or under certain other circumstances, each Right will entitle its holder to purchase, at the Right's then current exercise price, shares of common stock of the other person having a value of twice the Right's exercise price.

In 2008, we amended the Rights Agreement. Under this amendment, the expiration of the Rights was extended ten years, from April 6, 2008 to April 6, 2018. We will generally be entitled to redeem the Rights in whole, but not in part, at \$.01 per Right, subject to adjustment. No Rights were exercisable under the Rights Agreement at December 31, 2009. The terms of the Rights generally may be amended by us without the approval of the holders of the Rights prior to the public announcement by us or an *Acquiring Person* that a person has become an *Acquiring Person*.

(12) RELATED PARTY TRANSACTIONS

As described in Note 2 Investment in BriteWater International, LLC, in June 2009, we entered into an Agreement in which we issued an aggregate of 1 million restricted shares of our common stock in exchange for 1,950 units of BWI, formerly referred to as UniPure. In June 2009, we entered into a Loan Agreement with BWI under which we may make secured loans to BWI up to a maximum amount of \$2.5 million. These loans are secured by all assets of BWI and are due and payable on or before June 30, 2012. As of December 31, 2009, we have made approximately \$1 million in aggregate secured loans to BWI. Two of the BWI existing unitholders, Quadrant Management, Inc., (*Quadrant*) and UniPureEnergy Acquisition, Ltd. (*UEA*) are affiliates of the Quasha family. Alan G. Quasha is the Chairman of the Board of Directors of HKN. There were no related party transactions during 2008 and 2007.

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In 2008, we created Canergy Growth Fund LLC (Canergy Growth Fund), a U.S. Virgin Islands non-registered investment fund, to invest in the Canadian junior oil and gas market, and Canergy Management, a U.S. Virgin Islands company, to manage the Canergy Growth Fund as well as other future possible Canadian investment opportunities. Our investments in the Canergy Growth Fund and Canergy Management were variable interests. Therefore, we consolidated the assets, liabilities and results of operations for these two entities. With the dramatic decline in the U.S. and foreign stock markets, and in order to avoid future additional significant losses, late in 2008, Canergy Growth Fund divested of all of its common stock holdings in Canadian junior oil and gas companies. In addition, the third-party investor exercised their right to voluntarily withdraw from the Canergy Growth Fund and Canergy Management, and HKN became the sole participant in both the Canergy Growth Fund and Canergy Management. In the fourth quarter of 2009, management decided to discontinue the Canergy Growth Fund and Canergy Management.

As discontinued operations, the operations for Canergy Growth Fund and Canergy Management for all periods presented have been combined into a single line item, net of taxes. The following tables provide summarized income statement information related to Canergy Growth Fund s and Canergy Management s discontinued operations:

	2009	Years Ended December 31, 2008	2007
Trading losses and other income from discontinued operations, net	\$	\$ (740)	\$
Loss from discontinued operations before income tax expense		(1,049)	
Income tax expense			
Loss from discontinued operations	\$	\$ (1,049)	\$

(14) OTHER INFORMATION

Quarterly Data (Unaudited) The following tables summarize selected quarterly financial data for 2009 and 2008 expressed in thousands, except per share amounts:

	March 31	June 30	Quarter Ended September 30	December 31	Total Year
2009					
Revenues and other	\$ 2,728	\$ 3,394	\$ 3,099	\$ 3,147	\$ 12,368
Net loss	(1,118)	(159)	(614)	(1,454)	(3,345)
Net loss attributed to common stock	(1,211)	(348)	(527)	(1,383)	(3,469)
Basic and diluted loss per common share	\$ (0.13)	\$ (0.04)	\$ (0.05)	\$ (0.15)	\$ (0.37)
2008 (1)					
Revenues and other	\$ 6,280	\$ 7,073	\$ 5,751	\$ 1,159	\$ 20,263
Net income (loss)	1,114	2,345	(3,265)	(27,148)	(26,954)
Net income (loss) attributed to common stock	1,053	2,256	(3,276)	(27,141)	(27,108)

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Basic and diluted income (loss) per common share	\$	0.11	\$	0.23	\$	(0.34)	\$	(2.83)	\$	(2.83)
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(1) In the fourth quarter 2009, we discontinued the Canergy Fund and Canergy Management segment which were created in June 2008. Therefore, the quarterly data was restated retroactively.

Significant Customers In 2009, we had one domestic purchaser of our Gulf Coast production which represented approximately 61% of our consolidated revenues. We do not feel that the loss of a significant

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purchaser would significantly impact our operations due to the availability of other potential purchasers for our oil and gas production.

Operating Segment Information We engage primarily in oil and gas development and production activities in the onshore and offshore Gulf Coast regions of South Texas and Louisiana as well as coalbed methane exploration and development activities in Indiana and Ohio. Our coalbed methane and oil and gas operations efforts in the United States are managed and evaluated by us as one operation. We operate primarily through traditional ownership of mineral interests in the various states in which we operate.

In the second quarter 2009, we created a new operating segment to reflect the consolidation of our investment in BWI. This entity holds the patents and equipment for OHSOL technology can be used to purify oilfield emulsions by breaking and separating the emulsions into oil, water and solids and to reduce the environmental impact for disposition of residual fuels and waste materials. Please see Note 2 Investment in BriteWater International, LLC. for further discussion.

Our accounting policies for each of our operating segments were the same as those for our consolidated financial statements. There were no intersegment sales or transfers for the periods presented.

See Note 16 Oil and Gas Disclosures for geographic information regarding our long-lived assets. Our financial information, expressed in thousands, for our operating segments is as follows for each of the three years in the period ended December 31, 2009:

	For the Year Ended December 31, 2009			
	HKN	BWI	Eliminations	Consolidated
Oil and gas revenues	\$ 10,185	\$	\$	\$ 10,185
Interest and other income	2,209		(26)	2,183
Oil and gas operating expenses	8,591			8,591
General and administrative expenses	2,836	361		3,197
Provision for doubtful accounts	183			183
Depreciation, depletion, amortization and accretion	3,524			3,524
Other losses (gains)	33	26	(26)	33
Equity in losses of Spitfire	225			225
Income tax benefit	(40)			(40)
Segment loss from continuing operations	\$ (2,958)	(387)	\$	\$ (3,345)
Capital Expenditures	\$ 2,425	127	\$	\$ 2,552
Total Assets	\$ 61,473	\$ 9,094	\$ (2,352)	\$ 68,215
Equity investment in Spitfire	\$ 1,608	\$	\$	\$ 1,608

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	For the Year Ended December 31, 2008			
	HKN	BWI	Eliminations	Consolidated
Oil and gas revenues	\$ 22,206	\$	\$	\$ 22,206
Trading losses	(4,344)			(4,344)
Interest and other income	2,401			2,401
Oil and gas operating expenses	10,801			10,801
General and administrative expenses	5,281			5,281
Provision for doubtful accounts	41			41
Depreciation, depletion, amortization and accretion	5,224			5,224
Other losses, net	121			121
Equity in earnings of Spitfire	(196)			(196)
Impairment of investment in Spitfire	4,618			4,618
Impairment of facilities	97			97
Full cost impairment	19,906			19,906
Income tax expense	275			275
Segment loss from continuing operations	\$ (25,905)	\$	\$	\$ (25,905)
Capital Expenditures	\$ 6,896	\$	\$	\$ 6,896
Total Assets	\$ 68,773	\$	\$	\$ 68,773
Equity investment in Spitfire	\$ 1,820	\$	\$	\$ 1,820

	For the Year Ended December 31, 2007			
	HKN	BWI	Eliminations	Consolidated
Oil and gas revenues	\$ 20,419	\$	\$	\$ 20,419
Trading revenues	680			680
Interest and other income	3,199			3,199
Oil and gas operating expenses	8,648			8,648
General and administrative expenses	5,950			5,950
Provision for doubtful accounts	(106)			(106)
Depreciation, depletion, amortization and accretion	6,107			6,107
Other losses, net	390			390
Equity in losses of Spitfire	50			50
Income tax expense	30			30
Segment income from continuing operations	\$ 3,229	\$	\$	\$ 3,229
Capital Expenditures	\$ 10,867	\$	\$	\$ 10,867
Total Assets	\$ 110,465	\$	\$	\$ 110,465
Equity investment in Spitfire	\$ 6,517	\$	\$	\$ 6,517

(15) EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share include no dilution and is computed by dividing income or loss attributed to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted earnings (loss) per share reflects the potential dilution that could occur if security interests were exercised or converted into common stock.

The following table sets forth the computation of basic and diluted earnings (loss) per share for the years ended December 31, 2009, 2008 and 2007 (in thousands).

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	Net Loss Attributed to Common Stock	2009 Weighted- Average Shares	Per Share Loss	Net Loss Attributed to Common Stock	2008 Weighted- Average Shares	Per Share Loss	Net Income Attributed to Common Stock	2007 Weighted- Average Shares	Per Share Income
<i>Basic EPS:</i>									
Income (loss) from continuing ops before cumulative effect	\$ (3,469)	9,270	\$ (0.37)	\$ (27,108)	9,588	\$ (2.83)	\$ 2,965	9,799	\$ 0.30
<i>Effect of dilutive securities</i>									
Preferred stock and warrants (A)									
Diluted earnings per share	\$ (3,469)	9,270	\$ (0.37)	\$ (27,108)	9,588	\$ (2.83)	\$ 2,965	9,799	\$ 0.30

(A) Our Series G1, Series G2 and Series M Preferred and common stock warrants which were outstanding in the periods presented were excluded from the calculation of diluted earnings per share as their effect would have been antidilutive.

(16) OIL AND GAS DISCLOSURES (unaudited)

Costs incurred in property acquisition, exploration and development activities, expressed in thousands:

	Year Ended December 31,		
	2009	2008	2007
Domestic costs incurred:			
Acquisition of properties			
Evaluated	\$	\$	\$
Unevaluated			
Exploration	71	837	5,000
Development	2,017	4,442	5,734
Total domestic costs incurred	\$ 2,088	\$ 5,279	\$ 10,734

Capitalized Costs Relating to Oil and Gas Producing Activities, expressed in thousands:

	As of December 31,		
	2009	2008	2007
Capitalized costs:			
Unevaluated properties	\$ 5,099	\$ 4,874	\$ 7,768
Evaluated properties	200,197	197,534	187,817
Production facilities	1,004	1,023	1,152
Total capitalized costs	206,300	203,431	196,737
Less accumulated depreciation, amortization and full cost impairment	(171,243)	(168,227)	(143,760)
Net capitalized costs	\$ 35,057	\$ 35,204	\$ 52,977

Table of Contents**Results of Operations from Oil and Natural Gas Producing Activities**

(thousands of dollars)

	Year Ended December 31,		
	2009	2008	2007
Oil and natural gas revenues	\$ 10,185	\$ 22,206	\$ 20,419
Less:			
Oil and natural gas operating costs	8,591	10,801	8,648
Depreciation and amortization	2,936	4,593	5,481
Accretion expense	392	363	379
Income tax expense (benefit)	(40)	50	30
	11,879	15,807	14,538
Results of operations from oil and natural gas	\$ (1,694)	\$ 6,399	\$ 5,881

Oil and Gas Reserve Data (Unaudited) The following information is presented with regard to our proved oil and gas reserves. The reserve values and cash flow amounts reflected in the following reserve disclosures are based on a simple average of the first day of the month price for the period of January 1, 2009 to December 1, 2009, in accordance with ASC 932, *Oil and Gas Reserve Estimation and Disclosure* and the Securities and Exchange Commission's Final Rule, *Modernization of the Oil and Gas Reporting Requirements*, which were adopted for the disclosures for the year December 31, 2009.

We were unable to obtain the reserve information necessary from our equity method investment in Spitfire since Spitfire's most recent reserve report data is based on a calendar year end of March 31, 2009. After contacting Spitfire for updated reserve estimates as of December 31, 2009, they indicated these estimates are not available and would not be available to the public. In addition, their reserve report is not compiled in accordance with the SEC guidelines. Therefore, Spitfire has not been included in our Standardized Measure of Discounted Future Net Cash Flows relating to proved oil and gas reserves.

Standardized measure relates to the estimated discounted future net cash flows, as adjusted for our asset retirement obligations, and major components of that calculation relating to proved reserves at the end of the year in the aggregate and by geographic area, based on average prices, costs, and statutory tax rates and using a 10% annual discount rate. Prices at December 31, 2009 were based on a simple average of the first day of the month price for the period of January 1, 2009 to December 1, 2009 of \$61.18 per barrel and \$3.87 per mmbtu, as adjusted by field for quality, transportation and regional price differentials. Prices at December 31, 2008 were based on the NYMEX prices of \$44.60 per barrel and \$5.62 per mmbtu, as adjusted by field for quality, transportation and regional price differentials.

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Standardized Measure of Discounted Future Net Cash Flows Relating to Proved Oil and Gas Reserves:

	Unaudited, in thousands
December 31, 2008:	
Future cash inflows	\$ 93,494
Production costs	(48,254)
Development costs	(17,103)
Future income taxes	
Future net cash flows	28,137
10% discount factor	(4,877)
Standardized measure of discounted future net cash flows (1)	\$ 23,260
December 31, 2009:	
Future cash inflows	\$ 110,189
Production costs	(55,121)
Development costs	(17,957)
Future income taxes	
Future net cash flows	37,111
10% discount factor	(9,517)
Standardized measure of discounted future net cash flows (1)	\$ 27,594

(1) Cash flows associated with asset retirement obligations are included in the Standardized Measure of Discounted Future Net Cash Flows.

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	2009	(Unaudited) 2008 (in thousands)	2007
Total			
Standardized measure beginning of year	\$ 23,260	\$ 93,939	\$ 50,879
Increase (decrease)			
Sales, net of production costs	(3,906)	(11,405)	(11,889)
Net change in prices, net of production costs	6,866	(55,617)	36,902
Development costs incurred	(17)	(1,251)	(1,361)
Change in future development costs	(647)	2,579	2,420
Change in future income taxes			
Revisions of quantity estimates	(1,688)	(21,614)	9,832
Accretion of discount	2,292	9,394	5,088
Changes in production rates, timing and other	(3,679)	(921)	(5,254)
Extensions and discoveries, net of future costs	4,898	8,156	8,976
Sales of reserves-in-place			(1,654)
Purchases of reserves-in-place	215		
Standardized measure end of year	\$ 27,594	\$ 23,260	\$ 93,939

(17) COMMITMENTS AND CONTINGENCIES

Operating Leases We lease our corporate and other office space. Total office lease payments during 2009, 2008 and 2007 totaled \$196 thousand, \$144 thousand and \$360 thousand, respectively, net of applicable sublease arrangements. Future minimum rental payments required under all leases that have initial or remaining noncancellable lease terms in excess of one year as of December 31, 2009 are as follows:

Year	Amount
2010	\$ 189,000
2011	78,000
2012	
2013	
Thereafter	
Total minimum payments required	\$ 267,000

BriteWater Contingencies Please See Note 2 Investment in BriteWater International, LLC for further discussion on BWI contingencies.

IRS Examination - On August 6, 2008, we received a Revenue Agent's Report in which the Internal Revenue Service (IRS) proposed an adjustment to our federal tax liability for the calendar year 2005. The proposed adjustment relates to the calculation of the adjusted current earnings (ACE) component of the alternative minimum tax and asserts that the Company recognized gain for ACE purposes on the sale of the

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Global PLC stock in 2005. In its proposed adjustment, the IRS alleges that the Company owes approximately \$3.6 million in tax for the year ended December 31, 2005. Penalties and interest calculated through December 31, 2009 in the amount of \$2.1 million could also be assessed. In response to the proposed adjustment and corresponding tax assessment, the Company filed a written protest and request for conference on September 5, 2008 to address the proposed adjustment with the Appeals division of the IRS. On October 29, 2008, we received an acknowledgement of receipt of our written protest and request for conference from the IRS Appeals Office. In April 2009, we filed our supplement to the written protest filed with the IRS. Based on correspondence received to date, the IRS Appeals Office is still considering the matter.

ASC 740, *Income Taxes* prescribes a recognition threshold of more-likely-than-not to be sustained upon examination. ASC 740 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosures and transition. Based on the requirements of ASC 740, we have recorded an income tax contingency, including interest and penalties, as of December 31, 2009, of \$225 thousand in our consolidated financial statements based, in part, on a preliminary indication of a probability-weighted fair value assessment of the Global stock. We intend to vigorously defend the proposed adjustment and strongly believe that the Company has meritorious defenses.

Operational Contingencies The exploration, development and production of oil and gas assets are subject to various, federal and state laws and regulations designed to protect the environment. Compliance with these regulations is part of our day-to-day operating procedures. Infrequently, accidental discharge of such materials as oil, natural gas or drilling fluids can occur and such accidents can require material expenditures to correct. We maintain levels of insurance we believe to be customary in the industry to limit its financial exposure. We are unaware of any material capital expenditures required for environmental control during this fiscal year.

(18) SUBSEQUENT EVENTS

We have evaluated events after the date of these financial statements, December 31, 2009 through February 18, 2010, the date that these financial statements were issued. There were no material subsequent events as of that date.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS

(3) Exhibits

- *23.1 Consent of Independent Registered Public Accounting Firm - Hein & Associates, LLP
- *23.2 Consent of Collarini & Associates (Independent Reserve Engineers)
- *23.3 Consent of CREST Engineering Services (Independent Reserve Engineers)
- *31.1 Certificate of the Chief Executive Officer of HKN, Inc. pursuant to section 302 of the Sarbanes-Oxley Act of 2002 (S.O. Act)
- *31.2 Certificate of the Chief Financial Officer of HKN, Inc. pursuant to section 302 of the S.O. Act
- *32.1 Certificate of the Chief Executive Officer of HKN, Inc. pursuant to section 906 of the S.O. Act
- *32.2 Certificate of the Chief Financial Officer of HKN, Inc. pursuant to section 906 of the S.O. Act
- *99.1 Collarini Reserve Report Summary
- *99.2 Crest Reserve Report Summary

* Filed herewith

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SIGNATURES

Pursuant to the requirements of the Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, on February 2, 2011.

HKN, INC.

/s/ Anna M. Williams

By: Anna M. Williams, Senior Vice President
and Chief Financial Officer (Principal Financial
Officer and Principal Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this report has been signed below by the following persons on behalf of the registrant and in the capacities on February 2, 2011.

Signature	Title
/s/ Anna M. Williams Anna M. Williams	Senior Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)
/s/ Mikel D. Faulkner Mikel D. Faulkner	Director, Chief Executive Officer and President (Principal Executive Officer)