

The SEC's Case Against Miller Energy:

A Lesson in Fair Value Measurements

Case

During fiscal year ended on April 30, 2011 (fiscal 2011) Miller Energy Resources, Inc. (Miller Energy) replaced its external auditors with KPMG LLP (KPMG) to perform an audit of the financial statements¹. John Riordan, CPA was the partner in charge. The Securities and Exchange Commission (SEC) asserts that KPMG and Riordan 1) did not undertake adequate procedures to assess the risks when accepting Miller Energy as a new client; 2) failed to acknowledge a lack of industry experience from the audit team; 3) failed to gather sufficient appropriate audit evidence to support the value of opening balances, particularly with regard to a recently purchased asset recorded as \$480 million in the financial statements; 4) did not undertake adequate procedures with regard to the use of a specialist and 5) failed to consider subsequent events.

Prior to a change in auditors for fiscal year ended 2011, Miller Energy acquired an oil and gas interest located in Alaska (Alaska Assets) through a competitive auction on December 10, 2009. The purchase included more than 600,000 acres of land, a massive offshore oil drilling platform, hundreds of wells, and oil and gas reserves. For the third quarter ended January 31, 2010, Miller Energy reported a value of \$480 million for the Alaska Asset in the financial statements even

¹ The enforcement release issued by the Securities and Exchange Commission (SEC) provided the background information for this case. Unless indicated otherwise, the quotations in this case are drawn from the following sources: Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3888* (August 15, 2017), and Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3779* (June 7, 2016).

though Miller Energy had recently purchased these assets for \$4.47 million (\$2.25 million in cash and the assumption of \$2.22 million in reported liabilities). Despite Miller Energy's overvalued assets, KPMG issued an unqualified audit opinion on Miller Energy's financial statements for the year ended April 30, 2011.

The SEC concluded that KPMG and Riordan exercised unreasonable and improper conduct during the review of Miller Energy's financial statements for the third quarter ended January 31, 2011 and during the audit for the year ended April 30, 2011. Such conduct resulted in violations of PCAOB standards and indicates of a lack of competence. After considering the remedial acts KPMG undertook, the SEC denied Riordan's privilege as an accountant to practice for two years and imposed civil money penalties of \$1,000,000 for KPMG and \$25,000 for Riordan.

Company Background

Miller Energy operated and explored oil and gas wells in Alaska. From 2002 to 2009, the company reported net losses and its stock price primarily traded at less than one dollar per share. Miller Energy's securities were listed on the New York Stock Exchange (NYSE) until September 2015. On October 1, 2015, Miller Energy filed a voluntary bankruptcy petition for reorganization. On March 29, 2016, the NYSE delisted Miller Energy's stock.

KPMG's Audit of Miller Energy

The SEC asserted that KPMG's 2011 financial statement audit and third quarter review were deficient and departed from the PCAOB standards. KPMG's improper professional conduct relates to the following:

1. New client risk assessment and competency of engagement team
2. Substantiating opening balances and use of a specialist
3. Subsequent events

New Client Risk Assessment and Competency of Engagement Team

When accepting Miller Energy as a client, KPMG was transitioning to a new system for assessing and recording client engagements. Consequently, the existing system did not include adequate guidance for new client acceptance. KPMG and Riordan initially designated Miller Energy as a "low risk" client. The SEC asserts that KPMG and Riordan failed to consider Miller Energy's low stock price from 2002 to 2009, the deteriorating financial status and historical net losses, an unusual bargain purchase transaction during the prior year, and Miller Energy's desperation to finance the acquired Alaska Assets. KPMG and Riordan later designated Miller Energy as an overall "medium risk" and, accordingly, failed to recognize the high risk associated with this new client acceptance.

The SEC also asserts that KPMG did not follow PCAOB Quality Control Standard requirement in QC40.06 and QC40.08 which illustrate the expected competencies in performing accounting, auditing, and attestation Engagements. KPMG failed to evaluate the competencies of the engagement partner when accepting Miller Energy as a new client. KPMG's core engagement team was comprised of three members. Although the Houston based senior manager had prior experience in the oil and gas industry, both Riordan and a Knoxville based senior manager did not.

As the lead engagement partner with insufficient experience auditing oil and gas companies, Riordan failed to recognize the potential risk due to a lack of the engagement team's industry specific experience and skills. As a result, Riordan and the auditing staff were not able to form sensible judgements when reviewing the work performed by internal and external specialists. The SEC asserts that KPMG engagement team's lack of adequate knowledge and understanding in the oil and gas industry directly contributed to the ignorance of potential issues in Miller Energy's financial statements.

Collecting Sufficient Appropriate Audit Evidence to Substantiate Opening Balances / Use of a Specialist

Miller Energy valued the Alaska Assets on their Balance Sheet at \$480 million. The Alaska Assets consisted of oil and gas properties with a fair value of \$370 million and fixed assets with a fair value of \$110 million. The following figure illustrates the composition of the reported \$480 million value of Alaska Assets:

Insert Figure 1 here

Auditing Opening Balances: After accepting Miller Energy as a new audit client, KPMG and Riordan were required to analyze the impact of opening balances on the current year's financial statements. In addition, they were required to determine if the predecessor auditor applied the correct auditing procedures to substantiate the prior year's ending balances. KPMG and Riordan realized that the predecessor auditor did not obtain and document adequate evidence regarding the valuation of the Alaska Assets, but KPMG and Riordan did not document

this conclusion in their work papers. Although KPMG and Riordan did examine the impact of opening balances in the current period's financial statements and performed additional auditing procedures, their procedures were not adequate to analyze the effect of the Alaska Assets on the current year's financial statements. The SEC asserts that they failed to understand how Miller Energy estimated the fair value of the Alaska Assets in the financial statements and they failed to assess whether the valuation of the Alaska Assets conformed to GAAP.

KPMG and Riordan did not examine publicly available bankruptcy records of the prior owner of the Alaska Assets. In addition, they did not consider the purchase price, the history in determining the fair value of the assets, the extensive marketing efforts prior to the bankruptcy court sponsored auction, the prior unsuccessful purchase offer amounts, or the designation "abandonment of the assets" as part of the former owner's bankruptcy. Although the purchase price was \$4.47million (\$2.25 million in cash and \$2.22 million in assumed liabilities), Miller Energy recorded the value of the Alaska Assets at \$480 million in its financial statements for the year ended April 30, 2011. KPMG and Riordan believed the discrepancy between the purchase price and recorded value in the financial statements was due to Miller Energy's bargaining skills. KPMG also believed Miller Energy had been the only bidder in bankruptcy court in late 2009. Publicly available bankruptcy court records reveal there had been two prior winning bidders in 2009 who had not closed on the transaction. These bids (\$8.1 million and \$7 million) had also been substantially lower than the value Miller Energy recorded in the financial statements.

Use of a Specialist: KPMG and Riordan relied on a third-party petroleum engineer firm and a third-party insurance broker to evaluate the reasonableness of the \$370 million and \$110 million fair value estimates, respectively. The petroleum engineer firm's reserve report included a

disclaimer indicating that the \$370 million estimate of the oil and gas properties was not for fair value purposes. In addition, the report included assumptions Miller Energy had provided an unsubstantiated forecasted information. Miller Energy had provided an unreasonably low forecast of \$237 million of operating and capital expenses related to the Alaska Assets to the petroleum engineer. The report refers to operating expenses of \$4 per barrel of oil equivalent (BOE) whereas the predecessor's records indicates historical operating expenses of the oil and gas reserves of \$32.50 per BOE in 2008 and \$55.42 per BOE in the first two quarters of 2009 (SEC, No. 3779, p.7). The projected underestimated operating expenses resulted in the overstated valuation of the Alaska Assets.

The reported \$110 million fair value of the fixed assets was based on a revised insurance report initially prepared by an independent insurance broker. In fact, Miller Energy and the previous owner had provided the \$110 million figure to the insurance broker in 2007. Miller Energy had overstated this value by double counting the value of the fixed assets. Since these fixed assets closely relate to the oil and gas reserves, the engineer firm's reserve report reflected the value of these fixed assets as part of the overall valuation of the oil and gas properties. In February 2010, Miller Energy asked the insurance broker for a report of the fair value of replacement costs of the fixed assets. The insurance broker indicated in an email reply that such a report could not be provided. However, Miller Energy refashioned the insurance report and made it appear as if a third party independently derived the \$110 million value.

In its work papers, KPMG referred to the insurance broker as "a third-party valuation specialist" who provided an estimated value of the fixed assets, although KPMG knew that the insurance broker was not an expert. When the core engagement team asked Miller Energy's management for the engagement letter for the insurance report, Miller Energy had been unable to locate the letter

and the core engagement team did not make further inquiries of the insurance broker. The following graph illustrates the composition of the reported \$480 million value of Alaska Assets:

Upon reviewing both the engineer firm's reserve report and the insurance report, KPMG and Riordan were aware that the reports did not provide appropriate support for the fair value of the acquired assets. As a result, the auditors elicited the help of KPMG's internal valuation specialist, Economic and Valuation Services (EVS), to calculate the estimated fair value based on their experience and expertise of the industry. KPMG stated that "EVS concluded that the methodologies used and conclusions reached by [the insurance broker] were reasonable." (SEC, No.3888, p. 10) It should be noted that the third-party insurance broker report did not actually include a description of the methodology. EVS provided an estimate for the oil and gas reserves ranging between \$331 million and \$375 million. This estimated range supported Miller Energy's reported fair value.

Had the auditors appropriately followed up, the auditors would likely have realized the insurance broker had not performed the valuation work for Miller Energy. The SEC asserts that KPMG and Riordan did not exercise due professional care and professional skepticism. In addition, they failed to comply with PCAOB standards regarding the use of specialists. They did not perform additional work to contact the insurance broker to evaluate the assumed methodology. Additionally, KPMG and Riordan failed to consider the nature, scope and extent of involvement of the specialists. The SEC asserts that KPMG and Riordan did not evaluate the professional qualifications of the specialists, nor did they provide sufficient guidance and supervision relating to the required scope and objectives of the EVS's procedures.

Subsequent Events

The SEC asserts that KPMG and Riordan failed to exercise due professional care and professional skepticism since they did not consider new evidence that emerged after fiscal year ended on April 30, 2011, but before the audit report issuance date in early August. On July 28, 2011, a financial blog, *TheStreetSweeper*, published an article alleging Miller Energy's valuation of the Alaska Assets had been inflated. Web based links provided new evidence of the bankruptcy court records and sources to support this assertion. Riordan was aware of the article the day it was published but did not review the new evidence. Had the auditors examined the evidence cited in the article, they likely would have concluded that Miller Energy overstated the fair value of the Alaska Assets in the financial statements.

On July 29, 2011, Miller Energy filed its Form 10K with the SEC. Miller Energy included KPMG's audit report dated July 29, 2011, which consisted of an unqualified opinion on Miller Energy's financial statements for fiscal 2011. KPMG, however, had not yet released the audit report to Miller Energy. Accordingly, Miller Energy released KPMG's audit report before obtaining KPMG's permission. Miller Energy attributed the premature and illegal filing to the miscommunication among Miller Energy staff.

Miller Energy's Fraud and the SEC's Case Against KPMG

On December 10, 2009, Miller Energy acquired the Alaska Assets through a competitive auction for \$2.25 million in cash and the assumption of approximately \$2.22 million in liabilities. Miller Energy reported a value of \$480 million for the Alaska acquisition for the third quarter ended January 31, 2010. The reported after-tax gain of \$277 million boosted Miller Energy's net

income to \$272 million, a dramatic rise compared with a \$556,097 reported loss for the same period in the prior year. The company's total assets, in turn, significantly increased by 5,000 percent due to the newly booked Alaska Assets. The Alaska Assets represented over 95% of the company's total assets. Prior to the acquisition, Miller Energy's stock price had closed at \$0.61 per share in December 2009. Three months later, the share price increased 982 percent to close at \$6.60 per share (SEC, No. 3779, p.4). The following table shows select financial results from Miller Energy's financial reports for the fiscal years before and after the Alaska acquisition. A comparison of percent change reveals the reported financial impact of the Alaska acquisition on December 10, 2009.

Insert Table 1 Here

Miller Energy's fraud was primarily attributed to its failure to comply with the GAAP standards in reporting the fair value of the acquired Alaska Assets. As defined in ASC 820, "fair value is 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." The petroleum engineer's reserve report in February 2010 provided the basis for the reported fair value of the Alaska oil and gas reserves. Miller Energy included the materially misstated value in its Form 10-Q for the third quarter of fiscal 2010 through 2015 and in the Form 10-K for fiscal years 2011 through 2014.

The SEC charged KPMG and Riordan with engaging in improper professional conduct. The SEC asserts that KPMG and Riordan failed to properly plan the audit of Miller Energy's fiscal 2011 financial statements according to PCAOB standards. KPMG and Riordan did not consider

the significant risks and the core engagement team was not competent or have the proficiency to handle the special case in the oil and gas industry. KPMG and Riordan did not exercise due professional care and professional skepticism to critically assess the audit evidence in its 2011 audit and 3Q2011 review. Specifically, KPMG and Riordan failed to act in accordance with the professional standards required by GAAP in analyzing Miller Energy's fair value assertions for the Alaska Assets. They did not test the data and methodology used to develop the fair value measurements, nor did they evaluate the competency, sufficiency and consistency of the audit evidence. There was a lack of audit documentation in the work papers to demonstrate KPMG and Riordan's comprehension of the purpose, source, and conclusion of the audit engagement.

Questions

1. *Use of Specialists:* KPMG and Riordan relied on the work of both internal and external specialists to evaluate the fair value of the Alaska Assets. Which specific sections of PCAOB AS 1105 (Audit Evidence) and AS 1210 (Using the Work of a Specialist) did KPMG and Riordan violate? Briefly explain each of the specific sections.
2. *Risk Assessment:* Miller Energy was graded as "low" risk client in KPMG and Riordan's initial client acceptance evaluation. In their initial assessment of risk, what factors did KPMG neglect to consider? Identify and explain how these factors should have resulted in the auditors assessing Miller Energy as "high" risk.
3. *Initial Audits and Opening Balances:* According to PCAOB AS 2610, auditors need to assess the impact of opening balances on the current period's financial statements. What should KPMG

and Riordan have considered in assessing the fair value of Miller Energy's Alaska Assets in their assessment of opening balances?

4. *Valuation of the Alaska Assets*: Miller Energy overstated the fair value of the Alaska Assets by more than \$400 million. How was the fair value determined? Why did it depart from the fair value measurements and disclosures required under GAAP ASC 820?

5. *Professional Skepticism*: The SEC asserted that KPMG and Riordan did not exercise due professional care and failed to maintain an attitude of professional skepticism in Miller Energy's audit engagement. Referring to PCAOB AS 1015, describe what professional skepticism means. Provide at least two examples where KPMG did not apply professional skepticism.

6. *Audit Documentation*: Identify and discuss two examples of deficiencies with KPMG and Riordan's work paper documentation.

7. *Subsequent Events*: Referring to PCAOB AS 2801, define subsequent events and describe the two types of subsequent events. What was KPMG and Riordan's responsibility pertaining to the two subsequent events in the 2011 audit of Miller Energy?

References

Association of Certified Fraud Examiners (ACFE). 2020. *Report to the Nations: 2020 Global Study on Occupational Fraud and Abuse*.

Financial Accounting Standards Board (FASB). 2011. *Fair Value Measurement*. GAAP ASC 820.
Public Company Accounting Oversight Board (PCAOB). 2016. *Due Professional Care in the Performance of Work*. AS 1015.

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Case Learning Objectives and Implementation Guidance

Introduction

Financial statement fraud, which entails an intentional material financial misstatement, is the costliest type of fraud. In fact, the Association of Certified Fraud Examiners (ACFE, 2020) discloses a median company loss of \$954,000 attributable to fraudulent financial statements in their most recent survey. The ACFE also states that external audits are the most common anti-fraud controls for companies and can substantially reduce the cost of fraud. When comparing the cost of fraud between companies with and without external audits, the ACFE reported a 46% reduction in median loss for companies with external audits. These findings highlight the importance of financial statement audits.

The auditing course is designed to teach accounting students how to properly plan and perform a financial statement audit. This course typically includes such core competencies as research, critical thinking, problem solving/decision making, ethics, communication, and teamwork skills. This case, designed to be used in an auditing course, is based on an actual SEC *Accounting and Auditing Enforcement Release* involving numerous auditing deficiencies. It is designed to supplement an auditing textbook. Since we based it on a real audit situation, we hope to make the topics in this case more interesting for the students and, as a result, increase student comprehension.

Learning Objectives

At the conclusion of the case, students should be able to:

- Explain and apply Public Company Accounting Oversight Board (PCAOB) Auditing Standards (Questions 1,3,5,7)
- Use research skills to locate and obtain appropriate auditing standards (Questions 1,3,4,5,7)
- Describe the role of specialists in an audit (Questions 1)
- Identify the risks associated with new client acceptance (Question 2)
- Recognize the impact of opening balances on the current year's financial statements (Question 3)
- Explain how the fair value of an asset is determined (Question 4)
- Explain the need for professional skepticism throughout an audit (Question 5)
- Explain the importance of documenting audit evidence in work papers (Question 6)
- Identify and explain the two types of subsequent events (Question 7)

Core competencies we address in this case include the following: research, critical thinking, problem solving/decision making, ethics, communication, and teamwork skills (if completed in groups).

Implementation Guidance

This case can be used in an undergraduate or graduate auditing course and the instructor has flexibility in determining the level of difficulty of this case.

- Timing, format, and comprehensiveness of the assigned case: We assigned the case in an undergraduate auditing course towards the end of the semester as a group project. The instructor can determine whether they wish for students to present this information as a presentation or as a written assignment. The instructor also has the option to assign select questions, in which case the instructor would eliminate the learning objectives that do not apply. This option might be more applicable for a graduate auditing course since students could go into more depth when arriving at solutions.
- Degree of research: This case requires students to research auditing issues using auditing standards and other professional sources. This research requirement is consistent with the research skills accounting professionals use, as well as with CPA exam requirements. Instructors can adjust the level of complexity as follows in order of complexity: 1) require the students to research all the standards assigned in the questions; 2) provide assistance to the students in locating the required standards; 3) provide the students with the relevant standards. The instructor may wish to require graduate auditing students to obtain and read the actual Accounting and Auditing

Enforcement Release (AAER No. 3888) on the SEC website (www.sec.gov) instead of the case summary to address higher level learning outcomes.

- Critical thinking: Instructors can consider requiring students to write an additional question and answers, given that students can be insightful, imaginative, and innovative. This option would provide insight to the instructor so that they may identify the areas in which students are focusing.
- Assessment: The instructor may include a case question on an exam in class or on a more comprehensive take home exam. Given an exam in class, the instructor has two options: 1) include the question without previously exposing the student to the question (and, therefore, eliminate the research component); 2) include the question after students research the question and discuss the solution in class. The second option would enable to instructor to more fully assess whether the student ultimately comprehends the issues. Based on our experience, students often miss important information when researching questions on their own. Class discussion can fill in this gap for the student. Student feedback after completion of the course supported this view.

Evidence of Efficacy

We obtained anonymous feedback from students in a pilot study after completion of the course. On a likert scale of 1 (strongly agree) to 5 (strongly disagree), students were asked to what extent they agreed the case helped them with regard to each of the stated learning objectives. Mean responses for each of the stated objectives ranged from 1 -1.9. Accordingly, all students somewhat

or strongly agreed the case helped them with regard to the learning objectives. Using the same likert scale, students also responded the case was realistic (mean = 1.25), interesting (mean =1.1), and effective in helping them to understand audit issues (mean = 1.25).

Students were also asked to provide open ended responses as to whether they recommend the case for future classes and whether they recommend any changes for improvement. All students recommended the case for future classes. They pointed out benefits such as confidence building and creativity. Students referenced the benefit of having a “hands on”, real life situation, which helped them understand audit issues presented in the textbook. Students suggested more such cases throughout an auditing course. We made minor modifications to the case to add additional financial statement details and a visual exhibit based on student suggestions.

We also obtained feedback from audit manager at a Big 4 firm and at a mid-size national firm. We made minor modifications to the case based on their suggestions. One manager stated that “this case is interesting and certainly would’ve piqued my interest as a student.” Another manager commented that “this was very interesting to read, and I enjoyed it.” Both managers recommended the case be used in the future.

Suggested Solutions (with questions repeated)

1. *Use of Specialists*: KPMG and Riordan relied on the work of both internal and external specialists to evaluate the fair value of the Alaska Assets. Which specific sections of PCAOB AS 1105 (Audit Evidence) and AS 1210 (Using the Work of a Specialist) did KPMG and Riordan violate? Briefly explain each of the specific sections.

Answer: KPMG and Riordan violated the following sections of PCAOB AS 1105 (Audit Evidence) and AS 1210 (Using the Work of a Specialist):

-AS1105.04: They did not plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for the unqualified opinion.

-AS 1105.10: They did not perform required inspection to examine the internal and external records and documents.

-AS 1105.17 & 18: They did not make necessary inquiries with the third parties (petroleum firm and insurance broker) to confirm the assumed valuation methodology and results.

-AS 1210. 08: They did not evaluate the professional qualifications (experience, license, and reputation) of the specialist (EVS) in determining that EVS possessed the necessary skill or knowledge in the oil and gas industry.

-AS 1210. 09: They did not obtain an understanding of the nature, scope, and extent of involvement of the work performed or to be performed by the third-party specialists.

-AS 1210. 12: They failed to (a) obtain an understanding of the methods and assumptions used by the specialists, (b) make appropriate tests of data provided to the specialist, and (c) evaluate whether the specialist's findings support the related assertions in the financial statements.

2. *Risk Assessment*: Miller Energy was graded as “low” risk client in KPMG and Riordan’s initial client acceptance evaluation. In their initial assessment of risk, what factors did KPMG neglect to consider? Identify and explain how these factors should have resulted in the auditors assessing Miller Energy as “high” risk.

Answer: KPMG did not have sufficient guidance and procedures for new client acceptance in the new system to which it was currently transitioning. Nevertheless, KPMG and Riordan did not pay enough attention to Miller Energy's exceptionally low stock price (regularly trading at less than \$1 per share) from 2002 to 2009, along with the historical net losses. They did not consider the unusually low purchase price of \$4.47 million in 2009 for more than 600,000 acres of land with oil and gas reserves recorded in the financial statements for \$480 million. All of the factors would have contributed to a conclusion of "high" risk assessment. In addition, since KPMG's engagement team lacked experience and skills in the oil and gas industry, the auditors may not have been capable of identifying high risk indicators.

3. *Initial Audits and Opening Balances:* According to PCAOB AS 2610, auditors need to assess the impact of opening balances on the current period's financial statements. What should KPMG and Riordan have considered in assessing the fair value of Miller Energy's Alaska Assets in their assessment of opening balances?

Answer: KPMG and Riordan should have considered whether the predecessor auditor obtained and documented adequate evidence for the valuation of the Alaska Assets. KPMG and Riordan also should have documented the conclusion in the work papers. In addition, they should have assessed whether the valuation of the Alaska Assets conformed to GAAP. By examining the publicly available bankruptcy records of the prior owner of the Alaska Assets, as well as the bidding offers (\$8.1 million and \$7 million) from two prior winning bidders who had not closed on the transaction, KPMG and Riordan should have noticed that the discrepancy of the purchase price (\$4.47 million) and recorded value (\$480 million) in its financial statements was not due to Miller Energy's bargaining skills but, rather, the relatively low real value of the Alaska Assets.

4. *Valuation of the Alaska Assets:* Miller Energy overstated the fair value of the Alaska Assets by more than \$400 million. How was the fair value determined? Why did it depart from the fair value measurements and disclosures required under GAAP ASC 820?

Answer: The \$480 million fair value of the Alaska Assets consisted of two components: 1) oil and gas properties with a fair value of \$370 million estimated by a third-party petroleum engineer firm and 2) fixed assets with a fair value of \$110 million estimated by a third-party insurance broker.

According to GAAP ASC 820, “fair value is 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.” The \$480 million fair value included in Miller Energy’s financial statements departed from the fair value measurements and disclosures required under GAAP ASC 820 since neither third-party report was prepared for fair value determination purposes. Miller Energy had provided false forecasted information to the petroleum engineer firm and had also provided the \$110 million figure to the insurance broker. Neither amount represented the price that market participants would be willing to pay for the Alaska Assets.

5. *Professional Skepticism:* The SEC asserted that KPMG and Riordan did not exercise due professional care and failed to maintain an attitude of professional skepticism in Miller Energy’s audit engagement. Referring to PCAOB AS 1015, describe what professional skepticism means. Provide at least two examples where KPMG did not apply professional skepticism.

Answer: In section .07 of AS 1015, professional skepticism is described as “an attitude that includes a questioning mind and a critical assessment of audit evidence.”

Example 1: KPMG and Riordan realized that the predecessor auditor did not obtain and document evidence regarding the valuation of the Alaska Assets. KPMG and Riordan should have pursued gathering evidence to substantiate Miller Energy's fair value of the Alaska Assets.

Example 2: After KPMG and Riordan asked Miller Energy's management for the engagement letter for the insurance report and management could not locate the letter, KPMG and Riordan did not make further inquiries of the insurance broker.

Example 3: KPMG and Riordan didn't evaluate the estimates and assumptions used in the third-party petroleum engineer firm and insurance broker's reports regarding the valuation of the Alaska Assets. KPMG and Riordan knew that these two reports didn't support the valuation of the Alaska Assets.

Example 4: KPMG and Riordan didn't follow up on the new evidence in the *TheStreetSweeper* article, which was published prior to the date of the auditor's report.

6. *Audit Documentation*: Identify and discuss two examples of deficiencies with KPMG and Riordan's work paper documentation.

Answer:

Example 1: KPMG and Riordan knew that the insurance broker was not an expert but documented in the work papers that the insurance broker was "a third-party valuation specialist". KPMG and Riordan used the insurance broker's estimated value of the fixed assets as audit evidence.

Example 2: KPMG and Riordan knew that the predecessor auditors didn't obtain, and document evidence related to the valuation of the Alaska Assets. KPMG and Riordan didn't document this information in its work papers.

7. *Subsequent Events*: Referring to PCAOB AS 2801, define subsequent events and describe the two types of subsequent events. What was KPMG and Riordan's responsibility pertaining to the two subsequent events in the 2011 audit of Miller Energy?

Answer: Per AS 2801, subsequent events refer to events or transactions that occur subsequent to the balance sheet date, but prior to the issuance of the auditor's report with the financial statements. The first type of subsequent event provides additional information to items or conditions that existed at the balance sheet date. The second type of subsequent event provides information to items or conditions that did not exist at the balance sheet date but occurred after that date.

For the information in *TheStreetSweeper* article on July 28, 2011, pertaining to the Alaska Assets value being inflated, KPMG and Riordan needed to follow-up on this new evidence. If the evidence did show that the Alaska Assets value was inflated, then an adjustment needed to be made to the 2011 financial statements for this first type of subsequent event.

The second subsequent event was on July 29, 2011, when Miller Energy filed their Form 10k, which included the auditor's report, before KPMG released its audit report to Miller Energy. This is an example of the second type of subsequent event, which probably wouldn't require disclosure in the 2011 financial statements.

Appendix A End of Course Student Survey

Miller Energy

We would appreciate your anonymous feedback about the case.

To what extent do you agree with the following statements (circle one):

1.	This case helped me to:	Strongly agree	Somewhat agree	Neutral	Somewhat disagree	Strongly disagree
a.	Apply Generally Accepted Auditing Standards to a real audit.	1	2	3	4	5
b.	Understand the need for professional skepticism throughout an audit.	1	2	3	4	5
c.	Understand how the fair value of an asset is determined.	1	2	3	4	5
d.	Recognize the impact of opening balances on the current year's financial statements	1	2	3	4	5
e.	Recognize the importance of documenting audit evidence in work papers.	1	2	3	4	5
f.	Determine the risks associated with new client acceptance	1	2	3	4	5
g.	Understand the role of specialists in an audit	1	2	3	4	5
h.	Use research skills to locate and obtain the auditing standards.	1	2	3	4	5
i.	Understand the types of subsequent events	1	2	3	4	5
2.	This case was:					
a.	Realistic	1	2	3	4	5
b.	Interesting	1	2	3	4	5
c.	Effective in helping me to understand audit issues	1	2	3	4	5
3.	Would you recommend that this case be used in the future? If not, please explain.					
4.	Would you recommend any changes to improve the case? If so, please explain.					

Figure 1

Composition of the reported \$480 million value of Alaska Assets

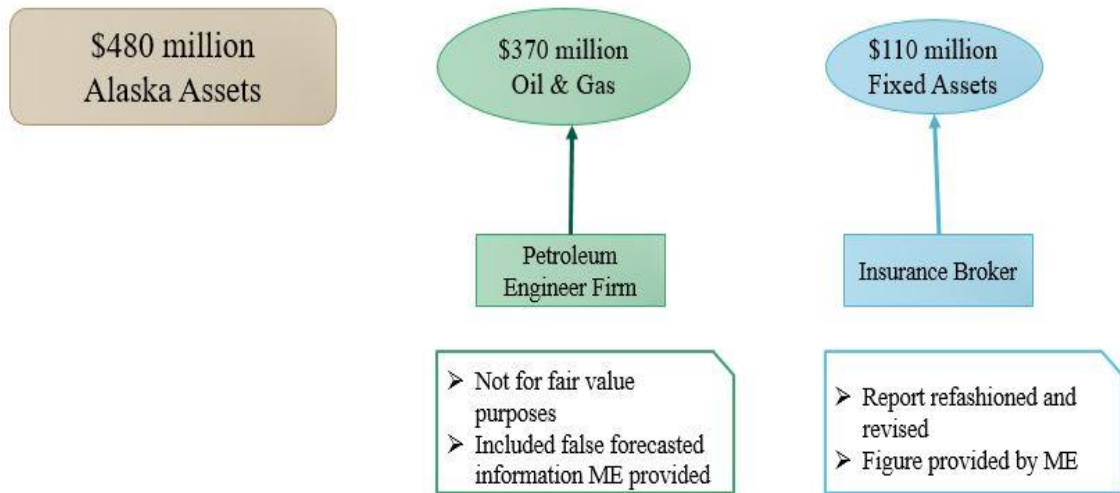


Table 1

Select financial results for the fiscal years before and after the Alaska acquisition

	Year Ended April 30, 2009	Year Ended April 30, 2010*	% Change
Net Fixed Assets	\$4,729,000	\$114,820,779	2,328%
Oil and Gas Properties	1,787,911	376,216,621	20,942%
Total Assets	9,941,733	500,452,155	4,934%
Total Liabilities	2,720,997	224,711,334	8,158%
Total Stockholder's Equity	7,220,736	275,740,821	3,719%
Oil and Gas Revenue	640,094	4,437,215	593%
Total Revenue	1,567,304	5,867,004	274%
Total Costs and Expenses	4,787,303	16,980,416	255%
Net Income	8,356,373	249,453,180	2,885%
Basic Income per Share	0.56	11.58	1,968%
Diluted Income per Share	0.56	8.29	1,380%

*Includes Alaska Assets