Miller Energy Resources:

Analysis of an Accounting Scandal and the Corresponding Audit Failure

D. Larry Crumbley

Jingming Ma*

BACKGROUND

On August 6, 2015, the SEC accused Miller Energy Resources of financial accounting and reporting fraud, along with audit failures by its auditors resulting from the valuation of certain Alaskan oil and gas assets. Established in 1967 and effectively defunct in 2015, Miller Energy Resources (Miller) was an independent exploration and production firm headquartered in Knoxville, Tennessee. According to the Securities Exchange Commission (SEC), Miller went public in 1996 by a reverse merger. For many years, its stock was traded in the over- the-counter- bulletin board exchange, often below one dollar per share (around 66 cents). [1] As of April 30, 2008, the firm had approximately 43,491 acres of lease in Tennessee with estimated proven reserves of 74,413 barrels in oil and 1,851,858 mcf in gas respectively.[2] So, at fiscal 2008

*The authors are, respectively, Professor at Texas A&M University – Corpus Christi and a recent graduate of the University of South Florida.

[1] U.S. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3731 U.S. Securities and Exchange Commission, Accounting and Auditing Enforcement Release No. 3731 Miller Energy Resources, Inc., et al., January 12, 2016, https://www.sec.gov/litigation/admin/2016/33-10002.pdf, January 12, 2016*, ¶ 5, https://www.sec.gov/litigation/admin/2016/33-10002.pdf

[2] Miller Petroleum, Inc., *2008 Annual Report,* Item 2. Description of Property, filed on August.10 2009, *https://www.sec.gov/Archives/edgar/data/785968/000116169709000534/0001161697-09-000534.txt*

year-end, Miller, with its total assets just a little under $3 million, could be consider a relative insignificant player.

In August 12, 2008, the firm filed a Form 8-K with the SEC reporting an election of new CEO, citing his experience in deal-making and investment banking acumen. They disclosed that the new CEO was the “son-in-law of Mr. Miller” and compensation structure, which includes, restrictive shares and options to buy 250,000 shares at $0.33 over the next four years.[3]

FROM TRIUMPH TO DEFEAT

Miller astounded or hoodwinked the stock market with a 2009 Alaskan oil and gas reserves acquisition. California based Pacific Energy Resource Ltd. was disposing of its assets in the Cook Inlet region of Alaska in its bankruptcy proceeding. The assets were on the market for a year and were in the process of being “abandoned” as there was significant cost to maintain the property. Miller ultimately won the bid with $2.25 million in cash along with the assumption of $2.22 million of liabilities.

[3] Miller Petroleum, Inc., *Form 8-K*, Item 5.02. Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers, filed on August.12 2008, https://www.sec.gov/Archives/edgar/data/785968/000114420408045763/0001144204-08-045763-index.htm

Perhaps the short-term monumental effect of this acquisition is best described in the Company's following 10-Q, which was filed on March 22, 2010:

> The Company acquired the Alaskan oil and gas assets, which include onshore and offshore production facilities, $215 million in proven energy reserves, $122 million in probable energy reserves and $31 million in possible energy reserves, providing total reserves of $368 million. At closing Miller paid Pacific Energy a purchase price of $2.25 million and provided $2.22 million for bonds. The acquisition included the following balance sheet items:

Assets		Liabilities and Equity	
Inventory	$212,228	Asset Retirement Liability	$1,789,995
Fixed Assets	110,000,000	Accounts Payable	3,251,252
Oil and gas properties	368,035,281	Deferred Income Tax Payable	195,509,846
Restricted Cash Long term	1,789,995	Fair value of equity issued	2,071,655
		Bargain Purchase Gain	277,414,756
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Total Assets	$480,037,504	Total Liabilities & Equity	$480,037,504[4]

Resulting from this acquisition, Miller's assets expanded almost fifty-fold, as shown in Exhibit 1, and the fixed assets and oil and gas property then accounted for almost all assets (under successful efforts).

[4] Miller Petroleum, Inc., *Form 10-Q for period ended January 31, 2010,* Page 16, filed on Mar. 22, 2010, *https://www.sec.gov/Archives/edgar/data/785968/000116169710000242/form10-q.txt*

Exhibit 1 – Partial Balance Sheet in March 22, 2010 10-Q

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MILLER PETROLEUM, INC.
CONSOLIDATED BALANCE SHEETS
ASSETS

	January 31, 2010 (Unaudited)	April 30, 2009
CURRENT ASSETS		
Cash and cash equivalents	$ 2,508,186	$ 46,566
Cash, restricted	131,499	1,982,552
Accounts receivable	690,605	124,815
Accounts receivable - related parties	30,699	19,882
Prepaid expenses	20,651	-
Inventory	232,071	87,120
Total Current Assets	3,613,711	2,260,935
Fixed Assets	115,924,957	5,751,017
Less: accumulated depreciation	(1,503,869)	(1,022,017)
Net Fixed Assets	114,421,088	4,729,000
OIL AND GAS PROPERTIES		
(On the basis of successful efforts accounting)	371,725,938	1,787,911
Land	526,500	406,500
Deferred interest	-	6,892
Prepaid offering cost	305,358	666,476
Cash - restricted, long-term	2,071,488	84,019
Deferred financing costs, net	580,648	-
Total Other Assets	3,483,994	1,163,887
TOTAL ASSETS	$ 493,244,733	$ 9,941,733

The accompanying notes are an integral part of these consolidated financial statements.

However, a quick analytical procedure in Table 1 reveals that, as of this balance sheet date, the vast majority of the potential exposure of the firm was in the Alaskan portion of the assets. Thus, an investor would expect much more audit efforts concentrated on this aspect for a clean opinion to be issued.

Table 1 - Selected Financial Data as of March 22nd 2010						
	Fixed Asset		Oil and Gas Properties		Total Asset	
	Dollar Amount	%	Dollar Amount	%	Dollar Amount	%
Alaskan Portion	$110,000,000	94.89%	$368,035,281	99.01%	$480,037,504	97.32%
Other	5,924,957	5.11%	3,690,657	0.99%	13,207,229	2.68%
Total	115,924,957	100%	371,725,938	100%	493,244,733	100%

Miller's fiscal year drew closed with an enormous $277 million bargain purchase gain and a clean financial opinion issued by its then auditor Sherb & Co., LLP. Of course, the market rewarded the firm with higher stock prices. During the period after the Alaskan acquisition until late 2013, Miller's stock price, in general rose to nearly $9 per share in spite of a questioning of its Alaskan asset valuation in 2011 (e.g., Thestreetsweeper),[5]and the firm obtained unqualified opinions for its financial statements even after switching to the prestige audit firm KPMG. In 2013, the company achieved a market capitalization of $393 million. After years of relative obscurity, the Alaskan acquisition propelled Miller into a seemingly unprecedented financial

[5] Davis, Melissa, and Janice Shell. "Miller Energy: This Hot 'Alaska' Stock May Be About to Melt (Part 1)." Seeking Alpha, Thestreetsweeper, 28 July 2011, seekingalpha.com/article/282825-miller-energy-this-hot-alaska-stock-may-be-about-to-melt-part-1. Thestreetsweeper article was a bombshell dropped on Miller and its auditor, making so many detailed challenges that later were even cited by the SEC.

success story. Indeed, the SEC, in hindsight, provided a recapitulation of the drastic market response to the Alaskan discovery:

> On December 10, 2009, the date of the transaction, Miller Energy's stock closed at $0.61 per share. By March 31, 2010, Miller Energy's stock closed 982% higher at $6.60 per share. Weeks later, its stock began trading on NASDAQ and, after moving to the NYSE a year later, reached an all-time high price on December 9, 2013 of $8.83 per share. [6]

Later, as the drop of global oil price in the fall of 2014 set off a fire storm in many oil and gas firms, Miller's situation started to turn for the worst. Specifically, as shown in Exhibit 2, citing the drastic decline in oil price, Miller disclosed in its annual filing in March 12, 2015, that its oil and gas properties had shrunk nearly 71% from the previous April, an impairment that includes an approximate $414.7 million related to directly to Alaskan assets (112,414k+152,887k+81,480K+7,596K).[7]

[6] U.S. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3731* U.S. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3731 Miller Energy Resources, Inc., et al., January 12, 2016,* https://www.sec.gov/litigation/admin/2016/33-10002.pdf, *January 12, 2016,* ¶ 12, https://www.sec.gov/litigation/admin/2016/33-10002.pdf

[7] Miller Energy Resources, Inc., *2015 Annual Report*, Item 1. Notes to Condensed Consolidated Financial Statements, Page 10, filed on Mar.12 2015, *https://www.sec.gov/Archives/edgar/data/785968/000078596815000012/a2015millq310q.htm#s0507180B2F5FF0C26125364734DDC8C9*

Exhibit 2 – Notes to Financial Statement March. 12, 2015 10-K

6. OIL AND GAS PROPERTIES AND EQUIPMENT

Oil and gas properties (successful efforts method) are summarized as follows:

	January 31, 2015	April 30, 2014
Property costs:		
Proved property	$ 476,694	$ 467,740
Unproved property	47,984	243,230
Total property costs	524,678	710,970
Less: Accumulated depletion	(334,956)	(66,143)
Oil and gas properties, net	$ 189,722	$ 644,827

On January 31, 2015, the significant and continued decline in crude oil prices during the third quarter of fiscal 2015 was identified as an impairment-related triggering event for proved properties. The Redoubt Unit and West McArthur River Unit failed the step 1 test which is based on undiscounted cash flows. The failure of step 1 required the Company to measure the estimated fair value of the Redoubt Unit and the West McArthur River Unit based on discounted cash flows. The step 2 analysis resulted in an impairment to proved and unproved properties of the Redoubt Unit and West McArthur River Unit of $81,480 and $67,586, respectively. The factors used to estimate the fair value of the Redoubt Unit and the West McArthur River Unit include, but are not limited to, estimates of reserve quantities, future commodity prices, the timing of future production, operating costs, capital expenditures and a risk adjusted discount rate. Because these significant fair value inputs are typically not observable, the Company has categorized the amounts as Level 3 inputs. As of January 31, 2015, the proved and unproved properties of the Redoubt Unit were written down to their estimated fair value of $42,044 and $2,318, respectively. Also as of January 31, 2015, the proved and unproved properties of the West McArthur River Unit were written down to their estimated fair value of $75,433 and $1,252, respectively. Also during the third quarter of fiscal 2015, the Company recorded a charge to exploration expense of $40,443 for other unproved properties, including Olson Creek #1 and Otter #1 due to changes in our drilling plans.

On October 31, 2014, the significant decline in crude oil prices during the second quarter of fiscal 2015 was identified as an impairment-related triggering event for proved and unproved properties. The Redoubt Unit failed the step 1 test which is based on undiscounted cash flows. The failure of step 1 required the Company to measure the estimated fair value of the Redoubt Unit based on discounted cash flows. The step 2 analysis resulted in an impairment to proved and unproved properties of the Redoubt Unit of $112,414 and $152,887, respectively. The factors used to estimate the fair value of the Redoubt Unit include, but are not limited to, estimates of reserve quantities, future commodity prices, the timing of future production, operating costs, capital expenditures and a risk adjusted discount rate. Because these significant fair value inputs are typically not observable, the Company has categorized the amounts as Level 3 inputs.

Then, on April 29, 2015, Miller filed a Form 8-K stating the SEC had made a preliminary determination to recommend a civil action against the company because of the valuation related to the Alaskan acquisition. Soon, Miller was delisted from NYSE and went bankrupt, leaving another tale of superstar company with distorted value bound for oblivion (bring with it the punctured investors' confidence). However, far from being a simple business failure, in hindsight, the SEC noted the numerous anomalies by Miller along with its auditors Sherb & Co. and KPMG in connection with the Alaskan acquisition that amount to a fraud and audit failures. Thus, the SEC issued various enforcement actions against four of Miller's executives and with its auditors. In addition, complaints filed on behalf of the shareholders abound.

THE ISSUES IN VALUATION

Without the Alaskan acquisition, Miller would perhaps never have risen to such prominence, and yet the valuation of the Alaskan assets also was the tragic unmaking of the firm and its executives. Problematic in two broad areas - the properties per se and the fixed assets attributed to the properties, the value of the Alaskan assets were distorted in excess of $400 million according to the SEC.

The Oil and Gas Properties

With respect to the oil and gas properties acquired in the business combination, Miller was required by Accounting Standard Codification (ASC) 805 *Business Combinations* to book the gain at fair value, and ASC 820 *Fair Value Measurements* mandates the choices of three approaches for fair value: the market approach, income approach, and cost approach. In their acquisition, Miller supposedly determined the valuation of its Alaskan oil and gas reserves on the income approach, which discounts the potential stream of future income into a single present value. Specifically, the SEC's investigation revealed that, on January 5, 2010, CEO of Miller's Alaska operation David Hall, engaged a petroleum consulting firm to prepare a reserve report in order to establish the fair value at the request of CFO Paul Boyd. When inputting to the reserve report, David Hall knowingly provided drastically underestimated expenses and thus was able to have the reserves overestimated. As far as for the extent of the expense underestimation, the SEC stated:

> Overall, the reserve report implied operating expenses of $4 per barrel of oil equivalent ("BOE") for all categories of reserves. That level of operating expenses was unreasonable in light of its predecessor's actual operating expenses of $32.50/BOE in 2008 and $55.42/BOE in the first half of 2009, before the wells were shut in.[8]

[8] U.S. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3779 Miller Energy Resources, Inc., et al., June 7, 2016*, ¶ 29, https://www.sec.gov/litigation/admin/2016/33-10090.pdf

The SEC made special mention of the Redoubt Shoal field in its enforcement action. The Redoubt Shoal field represented $291 million of the $368 million in fair value and accounted for much of the later impairments. Initially, the engineer firm that the prior owner of the assets had engaged informed David Hall that the field would be uneconomical and thus refused to assign any value to the field. However, the new engineer firm that David Hall engaged estimated this same field to be valued at $291 million because David Hall gave it underestimated expense number justified with supposedly leaner operation that Miller could run. However, Miller's internal documents showed that the supposedly leaner operation was falsified. Again, the SEC revealed the magnitude of the fraudulent reporting in detail:

> Internal documents maintained by Hall indicate that the cost to drill a new well in the Redoubt field was roughly $13 million. However, Hall told the petroleum engineer firm to use a cost of $4.6 million per well in its reserve report. . . Hall told the engineer firm that the offshore Redoubt Shoal field would cost $399,000 per month to operate when it actually had cost the seller more than $600,000 per month and when internal estimates show that Miller Energy and Hall expected the field to cost more than $800,000 per month once fully operational. Additionally, in some years, the report included zero expenses for operating the facilities in Redoubt Shoal and another field.[9]

SEC noted that the CFO had received admonition about the lack of control in expenses estimation in Alaska; yet without having instituted sufficient controls, he did adopt and report the numbers.

Apart from understated expenses, there were other prominent issues relate to the value presented by the reserve report. At the highest level, the firm used the rules for supplemental oil and gas disclosures (SMOG), and the reserve report itself explicitly stated that the numbers

[9] U.S. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3779 Miller Energy Resources, Inc., et al., June 7, 2016,* ¶ 27, https://www.sec.gov/litigation/admin/2016/33-10090.pdf

therein were not an estimate of fair market value. These SMOG numbers used in reserve reports are expressly not considered an estimate of fair market value. Also, in discounting cash flow, the CFO instructed the company to use the non-GAAP discount rate of pre-tax 10%. Furthermore, the value on the reserve report did not properly weight different categories of reserves (e.g., proved, probable, and possible), and the final number failed to consider some asset retirement obligations. In other words, the CFO merely summed the present value of proved, probable, and possible reserves.

An auditor or CPA auditing an oil and gas company should know that proved reserves have 90 percent confidence of being able to be recovered under favorable economic conditions, probable reserves, 50 percent, and possible reserves, a lower percentage. Analysts generally apply a discount factor of 0 to 20 percent for proved reserves, 50 percent for probable reserves, and a higher rate for possible reserves.

Auditors also should be aware that ASC 410-20 requires oil and gas companies to estimate an ARO liability generally on the spud date to handle any unavoidable costs of retiring the asset. A debit to a Capitalized Asset Retirement Costs account is established and amortized on a unit-of-production basis over the proved developed reserves (which reduces revenue). Generally, each month this liability (ARO) is increased by a corresponding debit to an Accretion Expense account. Accretion expense can be a huge number. For example, Chevron's 2017 Accretion Expense account was $668 million.

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." When the price of an asset is not observable, pricing should be based on market data obtained from sources independent of the reporting entity.

The Fixed Assets

Though valued less in dollar amount compared with that of the oil and gas properties, the valuation in the fixed assets appeared to be even more groundless. First and foremost, those fixed assets were the same operational assets valued in the reserve report as part of the operational assets' axillary. Therefore, Miller was double counting $110 million. Additionally, when in 2010, Miller's CFO asked the CEO of the Alaska's operation to provide a fair value for those fixed assets, Alaska CEO David Hall provided a "asset replacement cost study" that was dated September 5, 2008, but "revised" February 9, 2010. In reality, David Hall had changed the name of a previous insurance broker's "loss estimate study" to "asset replacement cost study" and supplied this report as backup for its fixed asset valuation. This report reflected only the number provided by Miller and the assets' prior owner.[10]

As such, through a combination of stratagems such as understating expense, non-GAAP discount rate, double counting assets, falsifying third party valuation, Miller grossly overstated its book value, and yet none of this should have worked, at least in theory, because given the gravity and materiality, one would expect that auditors would discover such misstatements.

THE ROLE OF AUDITORS

Throughout the debacle of Miller, two particular CPAs were swept away by the tidal wave in connection with the Alaskan valuation fraud. Then employed by Sherb & Co., LLP, Carlton W. Vogt, III was the engagement leader for the fiscal years 2009 and 2010 audits. In light of the SEC's enforcement release, Vogt's audit failure was manifested in several aspects. Regarding the auditing of the value of the oil and gas properties, Vogt's work in vetting the

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[10] U.S. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3779 Miller Energy Resources, Inc., et al., June 7, 2016,* ¶ 34, https://www.sec.gov/litigation/admin/2016/33-10090.pdf

specialist qualification was limited in determining the issuer experience as a petroleum engineer. The issuer was not a fair value appraiser, and thus his work was not audited in compliance with AU § 336.08. Furthermore, Vogt did not appropriately test the reported values, such as the unusually low expenses, nor did he even recognize the scope of the reserve report, stating that it was not to provide fair value, as what should have been done to satisfy AU § 336.09 and AU § 336.12. Also, Vogt's audit program was insufficient in auditing fixed assets by allowing Miller to provided information without consider the nature of whether those assets could be counted as part of the oil and gas properties.

At the engagement level, given the magnitude of the Alaskan assets in relation to Miller's total assets, Vogt should have, in theory, deploy the best resources. Instead, he assigned crucial audit procedures to inexperienced staff and did not sufficiently supervise the audit works. In retrospect, Vogt's fiscal year 2010 unqualified opinion was tantamount to a total audit failure, and thus, the SEC ruled in 2016 that Vogt was to be barred to practice before the SEC with the possibility to reapply after three years. Sherb & Co. was suspended in 2013 for improper professional conduct in another matter by the SEC and is now defunct.

In February 1, 2011 Miller replaced Sherb & Co., LLP with KPMG, citing the press statement that KMPG will be able to assist the growth in business and the expansion of shareholder base,[11] and John Riordan, the managing partner of KPMG's Knoxville, Tennessee office became in charge of Miller's engagement. Research has shown that normally, when the auditor is both a national and a city-specific industry specialist, the audit quality should be

[11] Miller Petroleum, Inc., *Form 8-K*, Item 99.1 Press Release dated February 4, 2011, filed on February 4, 2011, https://www.sec.gov/Archives/edgar/data/785968/000116169711000104/ex_99-1.htm

higher.[12] However, in the wake of this debacle, if the audit opinion from a small firm, such as that of Sherb & Co., LLP, is to be questioned for low quality, KPMG's John Riordan was no more effectual when it came down to Miller's financial statement. Riordan was a partner and a member of KPMG's Technology, Media, and Telecommunications practice,[13] and KPMG served as Miller's auditor from that point on until Miller's demise. The SEC alleged that KPMG's blunders started from the beginning as the audit firm did not have proper client acceptance and continuation policy, thus violating PCAOB's quality control standards (QC) - QC 20.14-.15.

According to the SEC,

> KPMG's initial evaluation, which was completed by Riordan and approved by KPMG management, failed to adequately consider Miller Energy's bargain purchase, its recent history as a penny-stock company, its lack of experienced executives and qualified accounting staff, its existing material weaknesses in internal control over financial reporting, its long history of reported financial losses, and its pressing need to obtain financing to operate the newly acquired Alaska assets. As a result, KPMG accepted Miller Energy as a client and incorrectly designated it as a "low" risk client.

Furthermore, at the leadership level of the engagement, both Riordan and the senior manager had no prior experience with oil and gas company, and the SEC also pointed out that KPMG did not have in place specific policies requiring an assessment of the engagement partner's competencies (thus violating QC 40.08), and the audit failure was partially due to Riordan's lack of experience to spot the problems and meaningfully to review the audit work. This lack of experience perhaps was most important reason for his failure to consider observable inputs as for the valuation of Miller's Alaskan assets; specifically, the prior sale price histories,

[12] Reichelt, Kenneth J., and Dechun Wang. "National and Office-Specific Measures of Auditor Industry Expertise and Effects on Audit Quality." *Journal of Accounting Research* 48, no. 3 (2010): 647-86. http://www.jstor.org/stable/40784868.

[13] U.S. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3888 KPMG LLP and John Riordan, CPA,* August 15, 2017, ¶ 5, https://www.sec.gov/litigation/admin/2017/34-81396.pdf KPMG LLP and John Riordan, CPA

unsuccessful marketing of the property, and court-approved abandonment were not given due consideration. But instead,

> KPMG and Riordan wrongly believed that the low purchase price seemed reasonable because Miller Energy had succeeded in negotiating the segregation of more valuable assets from less desirable ones and that, during the auction, the bankruptcy court disqualified other bidders for colluding with each other, making Miller Energy the only party bidding on the assets. Review of the bankruptcy records also would have revealed evidence . . . contrary to the company's nearly half-billion-dollar asset valuation.[14]

Apart from the separate opinions on internal controls, which Miller had never gotten a clean one from KPMG, Riordan as the successive auditor with potentially much more resources, audited Miller's Alaskan assets differently (compared with Vogt) in one key aspect-- the use of KPMG's Economic Valuation Service (EVS). According to the SEC, during the fieldwork, the EVS was mostly charged with the tasks of (1) evaluating the number provide by the reserve report and (2) that of the fixed assets. For evaluating the reserve report, the EVS examined three out of the twelve inputs of the reserve report (discount rate, risk weightings, and future oil prices), and concluded that all three inputs were inappropriate. Therefore, EVS re-estimated a range of these three inputs using its own assumption and then substituted the newly estimated three inputs along with other original inputs to a spreadsheet model to get its own valuation for the oil and gas properties. The EVS eventually estimated the oil and gas assets to be worth between \$331 million and \$375 million. However, not only was this value partially predicated on the original input from Miller's engineer consultant, but also EVS's three assumptions were themselves somewhat inexplicably flawed. For example,

> EVS indicated that the high values it observed could have been the result of the forecasted expenses Miller Energy used for the proved undeveloped ("PUD"), probable, and possible reserves. EVS asked the core engagement team to review the forecasted

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[14] U.S. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3888 KPMG LLP and John Riordan, CPA,* August 15, 2017, ¶ 33, https://www.sec.gov/litigation/admin/2017/34-81396.pdf

> expenses, as well as the financial forecast used in the discounted cash flow to determine whether it was overly optimistic. EVS reiterated its concerns to the core engagement team again on March 10, stating that the value numbers for "[t]he PUDs, probable and possible" reserves "are so high, it does not make sense . . .." On several occasions, EVS emphasized that it was relying on the core engagement team to assess the reasonableness of the forecasted expenses. Nevertheless, insufficient procedures were undertaken to assess the reliability of the forecast and estimated expenses used by Miller Energy to value the Alaska assets.[15]

Another example is that although KPMG had concluded that the 10% discount rate was in the reserve report was inappropriate and ultimately replaced it with a range of 14% to 17% in its own valuation, the rationale for such change was never clearly documented. Additionally, if Riordan properly reviewed the historical cost, he could have better questioned Miller's forecasted expenses (which were unusually low). The SEC noted that KPMG's EVS was aware of the issue of double counting of oil and gas property as fixed assets. In fact, EVS asked the Core Engagement Team about the interrelationship between that fixed assets and oil and gas properties, but the blunder here was the lack of proper documentations.

Riordan recognized that the original insurance report was unreliable because he knew that an insurance broker could not qualify as a valuation specialist. Yet KPMG's audit of fixed assets was half-baked in that it accepted Miller's corroborating estimate in 2011 (an estimate done without the assistance of a valuation specialist) as a "reasonable proxy" without its own adequate verification.

In its enforcement release, the SEC revealed some rather ironic, chilling, and perhaps even dramatic interactions between the EVS, Core engagement team, and the client. For instance,

[15] U.S. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3888 KPMG LLP and John Riordan, CPA,* August 15, 2017, ¶ 43, https://www.sec.gov/litigation/admin/2017/34-81396.pdf

> EVS's initial estimate, which assumed significantly higher oil prices than Miller Energy, was approximately $200 million. However, due to a flawed understanding of Miller Energy's valuation, EVS removed from its analysis the reserves adjustments – i.e., risk weightings – it had applied in that initial calculation, which caused the high-end of its estimate to increase to over $500 million. Approximately two weeks into EVS's procedures . . . KPMG, Riordan, and the rest of the engagement team discovered that management had used an insurance report to value the fixed assets. EVS's value range based on the reserve report alone appeared to suggest a value of $469 million to $531 million for the Alaska assets, which roughly approximated Miller Energy's overall $480 million valuation. Thus, when the insurance report surfaced, KPMG and Riordan became concerned that Miller Energy's estimate may have been *understated* due to the additional $110 million value reflected in the insurance report. . . EVS then made several additional changes to its valuation model, the rationale for which was not properly documented. Due to these changes, EVS's final estimated range appeared to support the company's fair value measurement for the Alaska assets.[16]

For the failures to test the data and use the work of EVS, the SEC ruled that KPMG failed to meet AU §§ 328, 342, and 336.

The SEC also charged that KPMG national office and the Department of Professional Practice (DPP) for mishandling the Miller engagement. To begin with, the national management had partaken the client acceptance process, which turned out to be inadequate as previously discussed. Also, upon the receiving the SEC's subpoena in August 2011, Riordan reached out to the national office and DPP for consultation, but the DPP did not cover the engagement's procedures for the fair value asset valuation, and thus failed to discover that the engagement's valuation relied on the some of the same faulty inputs from Miller. The SEC alleged that

> . . .had DPP made such inquiries, it could have discovered certain information that cast significant doubt about the reliability of Miller Energy's previously filed financial statements. This information included that the KPMG auditors were aware of the deficiencies in the predecessor auditor's work concerning the portion of the audit relating to the Alaska assets

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[16] U.S. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3888 KPMG LLP and John Riordan, CPA,* August 15, 2017, ¶ 61-62, https://www.sec.gov/litigation/admin/2017/34-81396.pdf

valuation and that neither of the reports provided to KPMG satisfied the requirements for fair value under ASC 820.[17]

In sum, the SEC ruled that KPMG and Riordan had improperly planned, supervised, and documented the audit and thus violating multiple sections in AU §§ 230, 311, 316, and 722. Although with additional procedures on verifying the valuation, one may argue the end result of KMPG's audit quality differed little compared with that of Vogt's audit in connection with Alaskan assets' valuation. After the SEC investigation, KPMG was ordered to review its policy and procedures and undergo proper training for its employees. The firm was ordered to pay roughly $6 million dollar (disgorgement of $4,675,680 plus $558,319 interest, in addition to civil penalty of $1,000,000 for KPMG and $25,000 for Riordan). Similar to the Vogt firm, Riordan was barred from practice before the SEC with the possibility to reapply after two years.

AFTERTHOUGHTS

Unrealistic assumptions and improper assessment of projected returns on investment in oil and gas reserves are a key risk in the oil and gas sector. In the early 2000s, Royal Dutch Shell Group was caught overestimating their oil reserves by 5.87 billion barrels. So, the Miller situation is another ageless paragon involving the malfunction of auditors and management in a systemic fashion. Although this situation involved little new ground-breaking fraud technique of its own, it shows once again how financial reporting fraud coupled with audit failures, or even honest incompetence, can exacerbate potential damages to investors. As this debacle has transpired along with the cyclicality of global energy prices, and the reshaping of the industry,

[17] U.S. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3888,* August 15, 201 KPMG LLP and John Riordan, CPA 7, ¶ 73, https://www.sec.gov/litigation/admin/2017/34-81396.pdf

perhaps it will redirect the public's attention back to the oil and gas industry. This financial statement fraud once again suggests the need of further examination regarding how an accounting firm could better protect investor against fraud as previous research has suggested that subject audit firm to extreme liability would not likely be effective in increasing the detection of fraud,[18] and yet a score of law suits followed the bankruptcies of Miller, along with dented public confidence. Thought Miller is an idiosyncratic situation involves the burst of a bubble built on too good to be true riches and auditor incompetency, but one thing for sure is that if assets value appeared to be too good to be true, such value probably is too good to be true.

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[18] Greg Burton, F., T. Jeffrey Wilks, and Mark F. Zimbelman. 2013. "How Auditor Legal Liability Influences the Detection and Frequency of Fraudulent Financial Reporting." *Current Issues in Auditing* 7 (2): P9–15. doi:10.2308/ciia-50566

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