

JONES ENERGY: A CASE STUDY

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ABSTRACT¹

BBAF was engaged to audit the financial statements of Jones Energy the year following Jones Energy's purchase of an oil field in Alaska. Jones paid \$4.5 million for the assets in the Alaskan oil field purchase and recorded the assets at \$480 million. BBAF did not follow PCAOB auditing standards and as a result issued an inappropriate opinion for the years 2011 – 2014.

¹ This case was based on the facts of United States of America Before The Securities And ... (n.d.). Retrieved from <https://www.sec.gov/litigation/admin/2017/34-81396.pdf>. Names were changed for educational purposes and some facts were omitted.

INTRODUCTION

Jones Energy Resources, Inc. is an Arkansas corporation that, in 2011, was headquartered in Arkadelphia Arkansas. Jones Energy operated and developed oil and gas wells in north and south-central Alaska. Founded in 1967 as an Arkansas-based oil and gas drilling contractor, the company went public via a reverse merger in 1996. Between 2002 and 2009, Jones Energy's stock price regularly traded below one dollar per share, and the company reported net losses in all years. It changed its name from Jones Petroleum, Inc. to Jones Energy Resources, Inc. in April 2011. Until March 29, 2016, Jones Energy's common stock was registered pursuant to Exchange Act Section 12(b). On October 1, 2015, Jones Energy and its subsidiaries filed a voluntary petition for reorganization under Chapter 11 of the Bankruptcy Code. As part of Jones Energy's bankruptcy plan, which became effective on March 29, 2016, all the company's common and preferred shares were canceled and extinguished. The company is now wholly owned by its former creditors and doing business under another name.

JONES ENERGY ACQUIRES AND OVERVALUES THE ALASKA ASSETS

In late 2008, the former owner of certain oil and gas interests located in Alaska (the "Alaska Assets") began extensive marketing efforts to sell those assets. These marketing efforts included hiring a leading financial advisory firm, which approached roughly 40 market participants and made available to them a data room containing materials about the value and operations of the assets.

In mid-2009, after these marketing efforts failed, the Alaska Assets were the subject of a bankruptcy court sponsored auction, with the winning bidder agreeing to pay \$8.1 million for the assets. A second entity, which bid \$7 million, was designated as the backup bidder. However, neither bidder closed on the bids.

After that, the former owner sought, and obtained, an order as part of its bankruptcy administration allowing title to the Alaska Assets to be abandoned. In approving the abandonment of the assets, the bankruptcy court concurred with the former owner's assessment that the Alaska Assets were of "no value or other benefit" to the former owner. A primary purpose of the abandonment order was to relieve the former owner of virtually all financial obligations relating to the Alaska Assets.

In the fall of 2009, Jones Energy – at the time, a thinly traded penny-stock company with operations primarily in Arkansas – learned that certain oil and gas interests located in Alaska (the "Alaska Assets") were in the process of being legally "abandoned" as part of the bankruptcy proceedings of a California-based energy company. The Alaska Assets consisted of leases covering 602,000 acres of mostly unproven exploratory oil and gas prospects. In addition to these prospects, the leases included five operative oil and gas wells located mainly on two fields, two major facilities, and an offshore platform.

Following Jones Energy's expression of interest in acquiring the Alaska Assets, the abandonment order was rescinded so that the assets could be sold. Jones Energy ultimately obtained the Alaska Assets via a competitive auction by outbidding a subsidiary of an NYSE-listed company, which at the time was the largest land drilling contractor in the world. Jones Energy's winning bid consisted

of \$2.25 million in cash plus the assumption of certain liabilities (reported at \$2.22 million). The transaction closed on December 10, 2009.

During its fiscal 2010, Jones Energy acquired the Alaska Assets for an amount the company estimated at \$4.5 million and then subsequently reported those assets at a value of \$480 million in its fiscal 2010 financial statements. This asset valuation violated generally accepted accounting principles (“GAAP”) and overstated the fair value of the assets by hundreds of millions of dollars.

Under the circumstances, applicable accounting principles required Jones Energy to record the Alaska Assets at fair value, with any resulting gain flowing from a “bargain purchase” to be recorded on the income statement. See Accounting Standards Codification (“ASC”) 805, Business Combinations. “Fair value” is described in ASC 820, Fair Value Measurement, as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (that is, an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.” ASC 820-10-35-9A.

In its first periodic filing with the Securities and Exchange Commission (Commission) following the acquisition (i.e., the 3Q2010 Form 10-Q), Jones Energy disclosed that it had assigned a value to the assets of \$480 million, comprised principally of \$368 million for oil and gas properties and \$110 million for fixed assets. It also recognized a one-time, after-tax bargain purchase gain of \$277 million. Following the acquisition, the Alaska Assets accounted for more than 95% of Jones Energy’s total reported assets.

Jones Energy, however, failed to conduct an appropriate analysis to calculate the fair value of the Alaska Assets and overstated the value of the acquired assets by hundreds of millions of dollars. For the recorded \$368 million fair value of the oil and gas properties acquired, Jones Energy improperly relied on a reserve report that was prepared by a third-party petroleum engineer firm under the guidelines for supplemental oil and gas disclosures, but not for fair value purposes. The report itself expressly disclaimed that any of the estimates set forth in the report were estimates of fair value.

Upon receiving the reserve report, Jones Energy merely recorded the sum of the estimates for the proved, probable, and possible reserves – \$368 million – as the fair value of the acquired oil and gas properties without undertaking any additional analysis. The report did not incorporate discount rates and risk adjustments for certain speculative reserve categories. In addition, the report contained unsubstantiated forecasted cost information, which was provided to the engineering firm by Jones Energy.

Jones Energy valued fixed assets such as facilities and pipelines ancillary to the oil and gas reserves at \$110 million. To support this fixed asset value, Jones Energy relied on an insurance report that purported to show replacement cost estimates from a third-party insurance broker. However, the report did not contain any estimates prepared by the broker. Rather, Jones Energy simply refashioned a pre-existing insurance report to make it appear that the broker had independently calculated the \$110 million replacement cost value. The value numbers in the report were provided to the broker by Jones Energy and the former owners of the Alaska Assets. The report contained

no third-party analysis of value. Those fixed assets were necessary to produce the oil and gas reserves and were included in the reserve report value. These assets had little to no independent value absent the reserves to which they related. As a result of these valuations, the financial reports that Jones Energy filed with the Commission materially misstated the value of its assets.

In August 2015, the Commission instituted administrative proceedings against Jones Energy, two of its former officers, and the engagement partner for the independent audit firm who audited the company's fiscal 2010 financial statements. Jones Energy filed for bankruptcy shortly thereafter.

BBAF – JONES ENERGY'S AUDITOR

BBAF LLP ("BBAF") is a Delaware limited liability partnership headquartered in New York City. BBAF is registered with the PCAOB and is the U.S. member firm of BBAF International, a Swiss cooperative, with over 90 offices in the U.S. BBAF was hired as the company's auditor during fiscal 2011, the year following the acquisition of the Alaska Assets, and issued an audit report containing an unqualified opinion on Jones Energy's fiscal 2011 financial statements.

BBAF continued as Jones Energy's auditor from 2011 until approximately October 2015, when Jones Energy filed a voluntary bankruptcy petition.

Barbara Crawford ("Crawford"), age 52, was a certified public accountant ("CPA") licensed to practice in Arkansas and Texas. Crawford joined BBAF's New York City office in 1987, before relocating to the Tulsa Oklahoma office in 1992. She was admitted to the partnership in 2000. She served as the BBAF engagement partner in charge of the 2011 audit of Jones Energy. Crawford was a member of BBAF's Technology, Media, and Telecommunications practice, and, since 2013, she has been the managing partner of BBAF's Little Rock Arkansas office, although she has remained primarily based out of BBAF's Tulsa office.

BBAF accepted Jones Energy as a client and designated it as a "low" risk client. Based on the information in the initial evaluation, BBAF and Crawford also assigned the Jones Energy engagement an overall risk grade of "medium." BBAF had recently transitioned to a new system for assessing and documenting prospective clients and engagements, BBAF had not established clear guidance and procedures relating to the use of the new system. BBAF's initial evaluation was completed by Crawford and approved by BBAF management. A client acceptance evaluation form completed by Crawford noted that the assigned engagement partner and the senior manager had no prior experience with oil and gas companies like Jones Energy, it stated that there were no concerns regarding the overall skills and experience of the engagement team. The BBAF engagement team was led by Crawford and two senior managers, one of whom resided in Houston, Texas, and was added to the team specifically for her oil and gas experience, as Crawford and the other, Little Rock-based senior manager had no oil and gas industry experience.

BBAF and Crawford determined that there had been no reportable disagreements between the prior auditors and Jones Energy and that the prior auditors did not resign or decline to stand for re-election. BBAF and Crawford concluded that the predecessor auditor did not document sufficient audit procedures or evidence obtained relating to the valuation of the Alaska Assets. However, the deficiencies in the predecessor auditor's work identified by BBAF and Crawford were not

documented in BBAF's workpapers. Due to the lack of documented procedures by the predecessor auditor, BBAF and Crawford performed additional audit and review procedures to obtain sufficient competent evidence regarding the impact of the opening balances on the current period's financial statements. However, these "additional procedures" were not documented.

The BBAF engagement team began with the interim review of the company's results for 3Q2011. BBAF issued audit reports containing unqualified opinions on Jones Energy's annual financial statements for fiscal years 2011 through 2014. Those audit reports were included in Jones Energy's Form 10-K filings that contained materially inflated asset values for the company's oil and gas properties. BBAF also provided review services related to Jones Energy's quarterly financial statements beginning in 3Q2011. During the 3Q2011 review and fiscal 2011 audit, the value of the Alaska Assets recorded by Jones Energy was substantially the same as the \$480 million value initially reported by Jones Energy following the acquisition of those assets in December 2009.

Jones Energy was run by a CEO with a background in commercial real estate and with little to no previous industry, corporate or executive experience. It also possessed a limited accounting staff led by a CFO with no prior industry experience. In regard to the CFO, who was the person responsible for recording the Alaska Assets' valuation, BBAF's workpapers state: He "does not appear to have adequate knowledge and experience in the oil and gas industry to facilitate the completeness and accuracy of industry-specific accounting and required financial statement presentation and disclosure" Based on BBAF's recommendation, the CFO was replaced shortly after the issuance of BBAF's audit report on Jones Energy's fiscal 2011 financial statements.

At the outset of the 3Q2011 review, Crawford reviewed the reserve report and sought assistance from BBAF's internal valuation specialists, Economic and Valuation Services ("EVS"), in connection with the core engagement team's review and audit procedures over the fair value of the Alaska Assets. Specifically, BBAF and Crawford tasked EVS with performing certain limited procedures relating to the Alaska Assets.

The procedures performed by EVS mainly consisted of (1) evaluating three assumptions in the reserve report and developing its oil and gas property valuation estimate using substitute inputs for those three assumptions and (2) reviewing the replacement costs Jones Energy used to fair value certain fixed assets. Most of the audit procedures relating to the fair value of the Alaska Assets occurred during and were performed concurrently with the 3Q2011 review. Accordingly, the results of those procedures were relied on in connection with both the third quarter review and the 2011 audit.

BBAF did not consider the sale price and history in evaluating the fair value of those assets. Despite the extensive but ultimately unsuccessful marketing efforts (which occurred during part of a roughly year-long period when the assets were made available for sale), the subsequent and ultimately unsuccessful purchase offers for the assets (each of which was for less than \$10 million), the bankruptcy court-approved abandonment of the assets (which relieved the prior owner of substantially all financial obligations for the assets), and Jones Energy's acquisition of the Alaska Assets in a competitive auction for a fraction of Jones Energy's recorded value. These facts were

readily ascertainable from the publicly available bankruptcy records of the prior owner of the Alaska Assets.

BBAF and Crawford did not assess the unobservable inputs – specifically, the assumptions underlying the reserve report and the insurance report – which Jones Energy used in its estimation of the fair value of the Alaska Assets. BBAF and Crawford recognized that the two reports the company used to support its fair value determination for the Alaska Assets were not appropriate for ascertaining fair value. With respect to the reserve report, Crawford knew that using the assumptions in the reserve report for fair value purposes was inappropriate. Moreover, regarding the insurance report, Crawford knew at the time that BBAF did not consider the insurance broker an expert. He believed that the insurance report was a starting point that EVS used when it came up with its independent estimates of the value based on their experience and understanding of the specific equipment.

Despite Crawford’s awareness that the insurance broker was not an expert, BBAF’s workpapers refer to the insurance broker as “a third-party valuation specialist” that “performed the appraisal of the fixed assets.” Other workpapers also list the insurance broker among the “specialists” whose work BBAF used as audit evidence and note that “EVS concluded that the methodologies used and conclusions reached by [the insurance broker] were reasonable.” BBAF and Crawford, however, had no information – other than the client’s representations – about the insurance broker’s methodology. The insurance report Jones Energy used for the fixed assets contained no description of any methodology, and BBAF never contacted the insurance broker to ascertain its supposed methodology.

BBAF and Crawford did not consider the nature and scope of the specialists’ work or the extent of the specialists’ involvement. There was no agreement at the onset of the valuation testwork concerning who was specifically responsible for the significant assumptions in Jones Energy’s valuation. Also, on several important issues, such as the consideration of observable inputs and the accounting treatment for the fixed assets, there was no agreement regarding the respective roles and responsibilities of EVS and the core engagement team. The core engagement team did not evaluate EVS’s substitute assumptions.

One week prior to the third quarter filing deadline Crawford sent EVS an email telling them that BBAF had already informed the company’s audit committee that the firm did not anticipate restatement of the valuation, which meant that the valuation of the Alaska Assets did not need to be included among the financial restatement items that BBAF had identified and that the company had been working “feverishly” to complete. Two days after Crawford’s email to EVS, BBAF and Crawford discovered that the company’s valuation did not include any reserve adjustment factors. BBAF and Crawford had received inconsistent representations from management regarding whether or not the values set forth in the reserve report incorporated reserve adjustment factors. BBAF and Crawford did not inquire about the reasons for Jones Energy having provided them with inconsistent information. Instead, EVS reapplied risk weightings to its model. 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.

The core engagement team asked management for the engagement letter setting forth the terms of the insurance broker's supposed valuation work. In response, the core engagement team was told that no such letter could be located. The core engagement team did not pursue the engagement letter further.

BBAF and Crawford did not sufficiently consider information that came to light shortly before BBAF issued its audit report on Jones Energy's fiscal 2011 financial statements. On July 28, 2011, *The Wall Street Vacuum*, a financial blog dedicated to "exposing corporate fraud," published a lengthy article that was extremely negative about Jones Energy and challenged the recorded valuation of the Alaska Assets. The article provided Web-based links to numerous bankruptcy court records and other public sources for its assertions questioning the valuation of the Alaska Assets. Crawford, the core engagement team, and a member of BBAF management became aware of *TheWallStreetVacuum* article on the day it was published.

BBAF management and national office personnel in Department of Professional Practice ("DPP") had considerable involvement in certain aspects of the Jones Energy engagement, both at the start of the engagement (with firm management's appointment of Crawford and acceptance of the company as a client) as well as during the summer of 2011 when multiple consultations substantially overlapped. One of these consultations involved restatements of prior-year financial statements unrelated to the Alaska Assets valuation. BBAF policies required DPP to expand its review beyond the possible restatement items and to consider "all significant issues."

Requirements:

1. Please identify and discuss issues in the case.
2. Research and document authoritative literature that addresses the issues identified above.