

CASE 1.1

ENRON CORPORATION

Synopsis

Arthur Edward Andersen built his firm, Arthur Andersen & Company, into one of the largest and most respected accounting firms in the world through his reputation for honesty and integrity. “Think straight, talk straight” was his motto and he insisted that his clients adopt that same attitude when preparing and issuing their periodic financial statements. Arthur Andersen’s auditing philosophy was not rule-based, that is, he did not stress the importance of clients complying with specific accounting rules because in the early days of the U.S. accounting profession there were few formal rules and guidelines for accountants and auditors to follow. Instead, Andersen invoked a substance-over-form approach to auditing and accounting issues. He passionately believed that the primary role of the auditor was to ensure that clients reported fully and honestly to the public, regardless of the consequences for those clients.

Ironically, Arthur Andersen & Co.’s dramatic fall from prominence resulted from its association with a client known for aggressive and innovative uses of “accounting gimmicks” to window dress its financial statements. Enron Corporation, Andersen’s second largest client, was involved in large, complex transactions with hundreds of special purpose entities (SPEs) that it used to obscure its true financial condition and operating results. Among other uses, these SPEs allowed Enron to download underperforming assets from its balance sheet and to conceal large operating losses. During 2001, a series of circumstances, including a sharp decline in the price of Enron’s stock, forced the company to assume control and ownership of many of its troubled SPEs. As a result, Enron was forced to report a large loss in October 2001, restate its earnings for the previous five years, and, ultimately, file for bankruptcy in December 2001.

During the early months of 2002, Andersen became the focal point of attention among law enforcement authorities searching for the parties responsible for Enron’s sudden collapse. The accusations directed at Andersen centered on three key issues. The first issue had to do with the scope of professional services that Andersen provided to Enron. Critics charged that the enormous consulting fees Enron paid Andersen impaired the audit firm’s independence. The second issue stemmed from Andersen’s alleged role in Enron’s aggressive accounting and financial reporting treatments for its SPE-related transactions. Finally, the most embarrassing issue was the massive effort of Andersen’s Houston office to shred Enron audit documents, which eventually led to the demise of the firm.

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Enron Corporation--Key Facts

1. Throughout Arthur E. Andersen's life, "Think Straight, talk straight" served as a guiding principle for himself and Arthur Andersen & Co., the accounting firm that he founded.
2. Arthur Andersen's reputation for honesty and integrity resulted in Arthur Andersen & Co. gaining stature in the business community and growing into one of the nation's leading accounting firms by the time of his death in 1947.
3. Leonard Spacek succeeded Arthur Andersen as managing partner of Arthur Andersen & Co. in 1947 and continued Andersen's legacy of lobbying for more rigorous accounting, auditing, and ethical standards for the public accounting profession.
4. When Spacek retired in 1973, Arthur Andersen & Co. was one of the largest and, arguably, the most prominent accounting firm worldwide
5. The predecessor of Enron Corporation was an Omaha-based natural gas company created in 1930; steady growth in profits and sales and numerous acquisitions allowed Enron to become the largest natural gas company in the United States by the mid-1980s.
6. During the 1990s, Kenneth Lay, Enron's CEO, and his top subordinate, Jeffrey Skilling, transformed the company from a conventional natural gas supplier into an energy trading company.
7. Lay and Skilling placed a heavy emphasis on "strong earnings performance" and on increasing Enron's stature in the business world.
8. Enron executives used hundreds of SPEs (special purpose entities) to arrange large and complex related party transactions that served to strengthen Enron's reported financial condition and operating results.
9. During 2001, Enron's financial condition deteriorated rapidly after many of the company's SPE transactions unraveled; in December 2001, Enron filed for bankruptcy.
10. Following Enron's collapse, the business press and other critics began searching for parties to hold responsible for what, at the time, was the nation's largest corporate bankruptcy.
11. Criticism of Andersen's role in the Enron debacle focused on three key issues: the large amount of consulting revenue the firm earned from Enron, the firm's role in many of Enron's SPE transactions, and the efforts of Andersen personnel to destroy Enron audit documents.
12. Andersen's felony conviction in June 2002 effectively ended the firm's long and proud history in the public accounting profession.

Instructional Objectives

1. To provide students with a brief overview of the history and development of the public accounting profession in the United States.
2. To examine the “scope of services” issue, that is, the threats to auditor independence posed by audit firms providing consulting services to their audit clients.
3. To examine the extent to which independent auditors should be involved in their clients’ decisions regarding important accounting and financial reporting issues.
4. To review recent recommendations made to strengthen the independent audit function.
5. To review auditors’ responsibilities regarding the preparation and retention of audit workpapers.

Suggestions for Use

I typically begin an auditing course by discussing a major and widely publicized audit case. Clearly, the Enron case satisfies those criteria. The purpose of presenting such a case early in the semester is not only to acquaint students with the nature of auditing but also to make them aware of why the independent audit function is so important. Many accounting students are not well acquainted with the nature of the independent auditor's work environment, nor are they generally familiar with the critical role the independent audit function plays in our national economy. Hopefully, cases such as this one provide students with a "reality jolt" that will stimulate their interest in auditing and, possibly, make them more inclined to pursue a career in the auditing field.

The Enron case also serves as a good starting point for an auditing course since it provides students with an overview of how the auditing profession developed and evolved in the United States over the past century. The vehicle used to present this overview is the history of Arthur Andersen & Co. You will find that the case attempts to contrast the “Think straight, talk straight” philosophy of Arthur E. Andersen, the founder of the Andersen firm, with the more business-oriented approach to auditing that his predecessors adopted in the latter decades of the twentieth century.

Consider asking one or more of your students to interview former Andersen personnel who are graduates of your school. I have found that many former Andersen partners and employees are more than willing to discuss their former employer and the series of events that led to the firm’s sudden collapse. These individuals typically suggest that federal prosecutors’ efforts to “bring down” the entire Andersen firm as a result of the document-shredding incident was not only unnecessary but also inequitable, an argument that many members of the accounting profession—including academics—find difficult to refute.

Suggested Solutions to Case Questions

1. A large number of parties bore some degree of responsibility for the problems that the Enron fiasco ultimately posed for the public accounting profession and the independent audit function. The

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following bullet items identify several of these parties [see bold-facing] and the role they played in the Enron drama.

- The **leadership of the Andersen firm** that allegedly focused too much attention on practice development activities at the expense of the public service ideal embraced by Arthur E. Andersen and other early leaders of the profession.
- Impertinent **corporate executives** who insisted on aggressive, if not illegal, accounting and financial reporting treatments.
- Individual auditors** who made shortsighted and/or unprofessional decisions that tainted the perceived integrity of all auditors.
- Regulatory authorities** that failed to take proactive measures to limit the ability of rogue corporate executives, accountants, and auditors to circumvent their professional responsibilities.
- Academics** who failed to goad their students into internalizing the accounting profession's high ethical principles.

2. One approach to answering this question is to review with your students the eight specific types of non-audit services that the Sarbanes-Oxley Act of 2002 prohibited auditors of public companies from providing to their clients. Listed next are those eight non-audit services.

- Bookkeeping or other services related to the accounting records or financial statements of the audit client
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources functions
- Broker or dealer, investment adviser, or investment banking services
- Legal services and expert services unrelated to the audit

Many of these services would eventually place auditors in situations in which they had to effectively audit their own work. For example, auditors providing “financial information systems design services” could be forced to evaluate the integrity of an accounting system they had designed for an audit client.

Providing “human resources” functions, such as executive search services, to audit clients could threaten auditors’ independence by causing them to evaluate the work product of high-ranking client employees who they had recommended that a client hire.

An audit firm that provided some type of “expert service unrelated to the audit” could find itself in a dicey situation if the given service proved to be less than expert quality. For example, if an audit firm recommended to a client a strategy for dealing with a labor strike or other work stoppage and that strategy proved ineffective, client executives would potentially have some degree of leverage to extract concessions from the audit firm during subsequent audit engagements.

3. Given the assumption that the Powers Report excerpts included in Exhibit 3 are accurate, one could plausibly argue that Arthur Andersen violated several of the ten generally accepted auditing standards, including the following:

- **Independence (second general standard):** by becoming too involved in Enron’s decisions for important accounting and financial reporting treatments, the Arthur Andersen auditors may have forfeited some degree of objectivity when they reviewed those decisions during the course of subsequent audits.

- **Due professional care (third general standard):** any violation of one of the other nine GAAS effectively results in a violation of the catchall due professional care standard.

- **Planning and supervision (first fieldwork standard):** a reliable quality control function, including proper audit planning decisions and effective supervision/review during an audit, should result in the identification of problematic situations in which auditors have become too involved in client accounting and financial reporting decisions.

- **Internal control evaluation (second fieldwork standard):** one could argue that given the critical and seemingly apparent defects in Enron’s internal controls, Andersen auditors failed to gain a “sufficient understanding” of the client’s internal control system.

- **Sufficient competent evidential matter (third fieldwork standard—under the current third fieldwork standard the auditor must obtain “sufficient appropriate” audit evidence):** many critics suggest that Andersen’s deep involvement in Enron’s aggressive accounting and financial reporting treatments may have precluded the firm from collecting sufficient competent evidence to support the audit opinions issued on the company’s financial statements (that is, the Andersen auditors may have been less than objective in reviewing/corroborating the client’s aggressive accounting and financial reporting treatments).

- **Reporting (fourth reporting standard):** If Andersen did not maintain its independence and objectivity while auditing Enron, the audit firm should have issued a disclaimer of opinion on the company’s periodic financial statements.

4. Note: The PCAOB has established the documentation requirements for the audits of publicly owned companies in *PCAOB Auditing Standard No. 3*, “Audit Documentation.” The documentation requirements that pertain to audits of other organizations can be found in *Statement on Auditing Standards No. 103*, “Audit Documentation,” that became effective for audits of financial statements for periods ending on or after December 15, 2006.

SAS No. 103:

This standard has been integrated into AU Section 339. Paragraph .03 of AU 339 provides the following general guidance to independent auditors.

“The auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached. Audit documentation:

- a. Provides the principal support for the representation in the auditor’s report that the auditor performed the audit in accordance with generally accepted auditing standards.

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- b. Provides the principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.”

Paragraph .32 of AU 339 notes that the “auditor should adopt reasonable procedures to retain and access audit documentation for a period of time sufficient to meet the needs of his or her practice and to satisfy any applicable legal or regulatory requirements for records retention.” This paragraph goes on to note that the retention period for audit documentation “should not be shorter than five years from the report release date.”

PCAOB No. 3:

This standard defines audit documentation as “the written record of the basis for the auditor’s conclusions that provides the support for the auditor’s representations, whether those representations are contained in the auditor’s report or otherwise” (para. .02). “Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit programs, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media” (para. .04).

PCAOB No. 3 notes that there are three key objectives of audit documentation: “demonstrate that the engagement complied with the standards of the PCAOB, support the basis for the auditor’s conclusions concerning every major relevant financial statement assertion, and demonstrate that the underlying accounting records agreed or reconciled with the financial statements” (para. .05).

This standard establishes an explicit benchmark that auditors can use to determine whether audit documentation is “sufficient.” “Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement to: a) understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and b) determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review” (para. .06). [Note: SAS No. 103 has a similar requirement—see AU 339.10.] PCAOB No. 3 generally requires auditors to retain audit documentation for seven years from the date the auditor gave the client permission to use the relevant audit report in connection with the issuance of a set of financial statements.

Regardless of whether an audit client is a publicly owned company or another type of organization, the audit workpapers are the property of the audit firm.

5. During and following the Enron debacle, wide-ranging recommendations were made by many parties to strengthen the independent audit function. Listed next are several of these recommendations, including certain measures that were incorporated in the Sarbanes-Oxley Act of 2002.

- Establish an independent audit agency. Some critics have suggested that to “cure” the paradoxical nature of the auditor-client relationship (that is, to eliminate the economic leverage that clients have on their auditors), the independent audit function should be performed by a government agency comparable to the Internal Revenue Service.

- Permit audit firms to provide only audit, reviews, compilations, and other “pure” attestation services to their clients, that is, prohibit the provision of all non-audit services to audit clients. (As mentioned in the suggested solution to Question 2, Sarbanes-Oxley prohibits audit firms from providing eight specific consulting services to their audit clients.)

- Require that audit clients periodically rotate or change their independent audit firms. (Sarbanes-Oxley requires that engagement and review partners be rotated every five years on audit engagements involving public companies.)

- Establish an independent board to oversee the audits of public companies. (Sarbanes-Oxley resulted in the creation of the Public Company Accounting Oversight Board “to oversee the audit of public companies that are subject to the securities laws . . .”)

- Require independent auditors to work more closely with their clients’ audit committees. (Section 204 of Sarbanes-Oxley is entitled “Auditor Reports to Audit Committees” and delineates the information that auditors should exchange with a client’s audit committee, including any alternative accounting treatments “preferred” by the auditors.)

- Establish more explicit statutory requirements that prohibit client executives from interfering with the work of their independent auditors. (Section 303 of Sarbanes-Oxley is entitled “Improper Influence on Conduct of Audits.” This section of the federal law makes it unlawful for corporate executives “to fraudulently influence, coerce, manipulate, or mislead” their company’s independent auditors.”)

6. Many critics of our profession suggest that beginning in the latter part of the twentieth century certain accounting firms gradually turned away from the public service ideal embraced by Arthur E. Andersen and other early pioneers within the profession and, instead, adopted a somewhat mercenary attitude toward the independent audit function. A key factor that certainly accelerated this trend was the profession’s decision in the 1970s, with the goading of the Federal Trade Commission and the courts, to drop bans on competitive bidding, client solicitation, and other ethical rules that effectively restrained competition among audit firms. The elimination of those rules enticed audit firms to begin competing against each other for the finite number of large corporate audits. Practices such as “lowballing” to gain such clients allegedly resulted in audit firms “cutting corners” on audits. Likewise, audit firms began vigorously marketing non-audit services to supplement their suddenly low-margin audit services.

A related factor that allegedly contributed to the move away from the public service ideal was the growing tendency for large audit firms to consider strong marketing skills, as opposed to strong technical skills, as the key criterion in determining which individuals would be promoted to partner. Finally, pure and simple greed is a factor that motivates most of us. The large and lucrative market for business consulting services over the past few decades may have enticed audit firms to focus more on becoming “strategic business advisers” to their clients rather than placing an unrelenting emphasis on the quality of their audits of those clients’ financial statements.

7. In the spring of 2000, the SEC began requiring public companies to have their quarterly financial reports (typically included in Form 10-Q filings) reviewed by their independent auditors. (Note: AU Section 722, “Interim Financial Information,” provides guidance to auditors on the “nature, timing, and extent of procedures to be applied” to a client’s interim financial information.)

Should quarterly reports be audited? In fact, many parties have advocated an even more extreme measure, namely, that independent auditors continually monitor and report on the integrity of their clients’ financial disclosures. In the current environment when information is distributed so readily and widely to millions of investors and other decision makers, the validity or utility of independent audits that focus on discrete time periods has been challenged. As recent history has

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proven, by the time that auditors issue their reports on a client's financial statements for some discrete period, the "horse may already be out of the barn"—the "horse" in this case being the damage to investors and other parties resulting from oversights and other misrepresentations in the given financial statements. This problem could be cured, or, at least, mitigated to some extent, by requiring auditors to provide real-time disclosures of potential problems in their clients' financial records.