Section 1

Ethics and Professional Responsibility

While the Sarbanes-Oxley Act of 2002 (SOX) has had a dramatic impact on all stakeholders in the financial reporting process, arguably the most dramatic change has been that the auditing profession is now regulated. The Public Company Accounting Oversight Board (PCAOB) is now responsible for setting all auditing standards pertaining to audits of publicly traded companies. The PCAOB is also required to perform detailed inspections of audit work completed and quality control processes employed by audit firms. These changes are sure to have a dramatic impact on the auditing profession. The following cases are designed to illustrate the ethical and professional responsibility of auditors in the post-Sarbanes auditing environment.

The case readings have been developed solely as a basis for class discussion. The case readings are not intended to serve as a source of primary data or as an illustration of effective or ineffective auditing.

Case 1.1

Enron: A Focus on Independence and Ethics

Synopsis

In its 2000 Annual Report, Enron prided itself on having "metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people."[1] Enron's strategy seemed to pay off. In 2000, it was the seventh largest company on the Fortune 500, with assets of $65 billion and sales revenues of over $100 billion.[2] From 1996 to 2000,

[1] Enron 2000 Annual Report, p. 7.

[2] Joseph F. Berardino, Remarks to U.S. House of Representatives Committee on Financial Services, December 12, 2001.

Enron's revenues had increased by more than 750 percent (over 65 percent per year), which was unprecedented in any industry.[3] Yet, just a year later, Enron filed for bankruptcy, and billions of shareholder dollars and retirement savings were lost.

In 2002, Enron's auditor Arthur Andersen LLP, one of the five largest international public accounting firms, was convicted on one charge of obstruction of justice in connection with the Enron audit. And although this conviction was overturned in 2005 by the United States Supreme Court, Andersen's decision to destroy evidence cast suspicion on whether Andersen was trying to cover up any guilt related to a failure to perform its professional responsibilities.

Arthur Andersen

Enron paid Arthur Andersen $46.8 million in fees for auditing, business consulting, and tax work for the fiscal year ended August 31, 1999; $58 million in 2000; and more than $50 million in 2001.[4] Andersen was collecting a million dollars a week from Enron in the year before its crash. Enron was one of Andersen's largest clients.

More than half of that amount was for fees that were charged for nonaudit services.[5] In 2000, for example, Enron paid Andersen $25 million for audit services, and $27 million for consulting and other services, such as internal audit services.[6]

In fact, Andersen had performed Enron's internal audit function since 1993. That year, Andersen had hired 40 Enron personnel, including the vice president of internal audit, to be part of Andersen's team providing internal audit

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[3] Bala G. Dharan and William R. Bufkins, "Red Flags in Enron's Reporting of Revenues and Key Financial Measures," March 2003, pre-publication draft (www.ruf.rice.edu/~bala/files/dharan-bufkins_enron_red_flags_041003.pdf), p. 4.

[4] Anita Raghavan, "Accountable: How a Bright Star at Andersen Fell Along with Enron," *Wall Street Journal,* May 15, 2002. Accessed from Factiva (February 25, 2005).

[5] Jane Mayer, "The Accountants' War," *New Yorker,* April 22, 2002. Accessed from LexisNexis Academic (February 25, 2005).

[6] Nanette Byrnes, "Accounting in Crisis," *BusinessWeek,* January 28, 2002. Accessed from LexisNexis Academic (February 25, 2005).

services.[7] In 2000, as SEC chairman Arthur Levitt was trying to reform the industry practice of an audit firm also offering consulting services to their audit clients, Enron's Chairman and Chief Executive Officer Ken Lay sent a letter to Levitt (the letter was secretly coauthored by Andersen partner David Duncan), in which he wrote:

> While the agreement Enron has with its independent auditors displaces a significant portion of the activities previously performed by internal resources, it is structured to ensure that Enron management maintains appropriate audit plan design, results assessment and overall monitoring and oversight responsibilities … Enron has found its "integrated audit" arrangement to be more efficient and cost-effective than the more traditional roles of separate internal and external auditing functions.[8]

Interestingly, at Andersen, an audit partner's compensation depended in large part on his or her ability to sell other services (in addition to auditing) to clients.[9] Therefore, the nonaudit services provided to Enron had a big impact on the salary of the lead Andersen partner on the Enron engagement, David Duncan, who was earning around $1 million a year.[10]

Close Ties between Enron and Andersen

After graduating from Texas A&M University, Duncan joined Andersen in 1981, made partner in 1995, and was named the lead partner for Enron two years later. Duncan developed a close personal relationship with Enron's Chief Accounting Officer Richard Causey, who himself had worked at Arthur Andersen for almost nine years. Duncan and Causey often went to lunch together, and their families had even taken vacations together.[11]

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[7] Thaddeus Herrick and Alexei Barrionuevo, "Were Auditor and Client Too Close-Knit?" *Wall Street Journal*, January 21, 2002. Accessed from ProQuest Research Library (February 26, 2005).

[8] "Letter from Kenneth Lay," Bigger than Enron transcript, Frontline, Aired on Public Broadcasting Service on June 20, 2002 (www.pbs.org/wgbh/pages/frontline/shows/regulation/congress/lay.html).

[9] Jane Mayer, "The Accountants' War," *New Yorker,* April 22, 2002. Accessed from LexisNexis Academic (February 25, 2005).

[10] Bethany McLean and Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (New York: Penguin Group, 2003), pp. 146–147.

[11] Susan E. Squires, Cynthia J. Smith, Lorna McDougal, and William R. Yeack, *Inside Arthur Andersen* (Upper Saddle River, NJ: Prentice Hall, 2003), p. 2.

Causey, who came to Enron in 1991, was appointed Chief Accounting Officer in 1997. Causey was responsible for recruiting many Andersen alumni to work at Enron. Over the years, Enron hired at least 86 Andersen accountants.[12] Several were in senior executive positions, including Jeffrey McMahon, who had served as Enron's treasurer and president, and Vice President Sherron Watkins.

Although Andersen had separate offices in downtown Houston, Duncan and up to one hundred Andersen managers had a whole floor available to them within Enron's headquarters in Houston.[13] Duncan once remarked that he liked having the office space there because it "enhanced our ability to serve" and to "generate additional work."[14] Andersen boasted about the closeness of their relationship in a promotional video. "We basically do the same types of things … We're trying to kinda cross lines and trying to, you know, become more of just a business person here at Enron," said one accountant. Another spoke about the advantage of being located in Enron's building: "Being here full-time, year-round, day-to-day gives us a chance to chase the deals with them and participate in the deal making process.…"[15]

In fact, Andersen and Enron employees went on ski trips and took annual golf vacations together. They played fantasy football against each other on their office computers and took turns buying each other margaritas at a local Mexican restaurant chain. One former senior audit manager at Andersen said that it was "like these very bright geeks at Andersen suddenly got invited to this really cool, macho frat party."[16]

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[12] Bethany McLean and Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (New York: Penguin Group, 2003), p. 145.

[13] Susan E. Squires, Cynthia J. Smith, Lorna McDougal, and William R. Yeack, *Inside Arthur Andersen* (Upper Saddle River, NJ: Prentice Hall, 2003), p. 126.

[14] Rebecca Smith and John R. Emshwiller, *24 Days: How Two Wall Street Journal Reporters Uncovered the Lies That Destroyed Faith in Corporate America* (New York: HarperBusiness, 2003), p. 289.

[15] Bethany McLean and Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (Penguin Group, 2003), p. 146.

[16] Flynn McRoberts, "Ties to Enron Blinded Andersen," *Chicago Tribune,* September 3, 2002. Accessed from Factiva (February 3, 2004).

Case Questions

1. What is auditor independence and what is its significance to the audit profession? What is the difference between independence in appearance and independence in fact?
2. Please consult Paragraph 32 of PCAOB Auditing Standard No. 2. In what ways, if any, was Arthur Andersen's independence in fact or in appearance potentially impacted on the Enron audit?
3. Refer to Section 201 of SOX. Please identify the services provided by Arthur Andersen that are no longer allowed to be performed. Do you believe that Section 201 was needed? Why or why not?
4. Please refer to Section 203 and Section 206 of SOX. How would these sections of the law have impacted the Enron audit? Do you believe that these sections were needed? Why or why not?