Case 1.2

Enron: A Focus on Quality Assurance

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."[17] 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.[18] From 1996 to 2000, Enron's revenues had increased by more than 750 percent (over 65 percent per year), which was unprecedented in any industry.[19] 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.

Andersen's Professional Standard Group

In addition to shredding documents, Andersen employees also allegedly changed memos that had been previously issued. These memos illustrated conflicts that existed between Andersen's group of expert accountants tasked with

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

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

[19] 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.

reviewing and passing judgment on difficult accounting, auditing, and tax issues—the Professional Standards Group (PSG)—and the Enron audit team. The PSG had objected strongly to several accounting issues related to the Enron audit. Their objections had been overruled by the lead Andersen partner on the Enron audit, David Duncan. The memos seemed to indicate that Duncan's team had misrepresented PSG's judgments to indicate their approval of Enron's accounting. In addition, Duncan allegedly helped carry out Enron's request to have one of the PSG partners removed from advising on any issues related to the Enron audit.[20]

PSG's Disapproval of Special Purpose Entities and the Audit Team's Response

In 1999, Enron's Chief Financial Officer, Andrew Fastow, spoke to David Duncan about Enron's plan to set up a special purpose entity (later called LJM), a financing vehicle used to access capital or increase leverage without adding debt to a firm's balance sheet. After the discussion with Fastow, Duncan asked for the advice of the PSG.

A member of the PSG, Benjamin Neuhausen, represented the group's disapproval in an e-mail written to Mr. Duncan on May 28, 1999: "Setting aside the accounting, (the) idea of a venture equity managed by CFO is terrible from a business point of view.… Conflicts of interest galore. Why would any director in his or her right mind ever approve such a scheme?" he wrote.[21]

In addition, PSG was firmly against the idea of Enron's recording gains on the sales of assets (or immediate gains on any transactions) to the Fastow-controlled special purpose entity. In response to the recording of gains, Duncan wrote in a June e-mail: "I'm not saying I'm in love with this either … But I'll need all the ammo I can get to take that issue on … on your point 1, (i.e. the whole thing is a bad idea), I really couldn't agree more." Yet, Duncan later told Mr. Fastow that Andersen would sign off on the transaction, under a few conditions, one of which was that

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[20] Mike McNamee, "Out of Control at Andersen," *BusinessWeek Online,* March 29, 2002. Accessed from Business Source Premier database (December 31, 2004).

[21] 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).

Mr. Fastow obtain the approval of Enron's chief executive and its Board of Directors.[22]

Shortly after, Carl Bass, who was promoted to PSG in December 1999, raised concerns over the sale of some equity options within the LJM special purpose entity. Bass wrote to his boss John Stewart in an e-mail, "This is a big item and the team apparently does not want to go back to the client on this. I think at a minimum the Practice Director needs to be made aware of this history and our opposition to the accounting."[23] However, the memo Duncan's team prepared to document the deal indicated that Bass "concurred with our conclusions."[24]

Bass continued to object to the LJM transaction, writing in an e-mail to Stewart (Bass's boss) in February 2000: "This whole deal looks like there is no substance. The only money at risk here is $1.8 million in a bankrupt proof special purpose entity (SPE). All of the money here appears to be provided by Enron...."[25] Duncan's team did not address Bass's concerns and, in fact, continued to misrepresent his views to the client.

In late 2000, Duncan asked Bass for more advice on how best to account for four Enron SPEs known as Raptors. Enron wanted to lump together the financial results for all the entities, so that the more profitable ones could offset losses being garnered by others. Bass opposed the idea. Nevertheless, Duncan later decided that Andersen would "accept the client's position," with some modifications.[26]

In February 2001, Andersen held a routine annual risk-assessment meeting to determine whether to keep Enron as a client. Some partners raised concerns related to how much debt Enron was *not* putting on its balance sheet,

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[22] 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).

[23] Carl E. Bass, Internal E-Mail to John E. Stuart, "Subject: Enron Option," December 18, 1999.

[24] Mike McNamee, "Out of Control at Andersen," *BusinessWeek Online* March 29, 2002. Accessed from Business Source Premier database (December 31, 2004).

[25] Carl E. Bass, Internal E-Mail to John E. Stewart, "Subject: Enron Transaction," February 1, 2000.

[26] 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).

Fastow's conflict of interest, and the lack of disclosure in the company's financial footnotes.[27] Duncan reassured his fellow partners.

Carl Bass was removed from the Enron account in March 2001. Bass wrote to Stewart (Bass's boss) in an e-mail: "Apparently, part of the process issue stems from the client (Enron) knowing all that goes on within our walls on our discussions with respect to their issues.… We should not be communicating with the client that so and so said this and I could not get this past so and so in the PSG.… I have first hand experience on this because at a recent EITF meeting some lower level Enron employee who was with some else [sic] from Enron introduced herself to me by saying she had heard my name a lot— 'so you are the one that will not let us do something.… ' I have also noted a trend on this engagement that the question is usually couched along the lines 'will the PSG support this?' When a call starts out that way, it is my experience that the partner is struggling with the question and what the client wants to do."[28] Stewart complained to a senior partner about Bass's removal. Duncan called Mr. Stewart and explained that two Enron executives, Richard Causey and John Echols, had pushed for Bass's removal.[29]

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In October 2001, Enron announced that it had a loss of $600 million and a reduction of shareholder equity of $1.2 billion in its third quarter of that year; and that the SEC was conducting an investigation into an issue related to one of its partnerships. At that time, Bass discovered the memos written by the audit team that claimed he agreed with Enron's accounting. Bass asked that some of the memos be changed to reflect his true judgments.[30] In November, Enron announced that it would need to restate its financial statements for the previous five years to

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[27] Mimi Swartz, *Power Failure: The Inside Story of the Collapse of Enron* (New York: Doubleday, 2003), pp. 235–236.

[28] Carl E. Bass, Internal E-Mail to John E. Stewart, "Subject: Enron," March 4, 2001.

[29] 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).

[30] Anita Raghavan, "Accountable: How a Bright Star at Andersen Fell Along with Enron," *Wall Street Journal,* May 15, 2002.

account for $586 million in losses.[31]

Case Questions

1. Please explain why an accounting and auditing research function (like Andersen's PSG) is important in the operations of a CPA firm. What role does the function play in completing the audit?
2. Please consult Section 103 of SOX. Do you believe that the Engagement Leader of an Audit (like David Duncan on the Enron audit) should have the authority to overrule the opinions and recommendations of the accounting and auditing research function (like the PSG)? Why or why not? Do you think that a PCAOB inspector would approve of this practice?
3. After Carl Bass was removed from the Enron account, he indicated to his boss that he did not believe Enron should have known about internal discussions regarding accounting and auditing issues. Do you agree with Bass's position? Why or why not?
4. Please consult Section 203 of SOX. Do you believe that this provision of the law goes far enough, that is, do you believe the audit firm itself (and not just the partner) should have to rotate off an audit engagement every five years? Why or why not?

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[31] It was also foreshadowed by Enron's announcement in October 2001 that it had a loss of $600 million and a reduction of shareholder equity of $1.2 billion in its third quarter of that year; and that the SEC was conducting an investigation into an issue related to one of its partnerships.