Section 4

Audit of Accounts, Processes, and Assertions

In formulating the post-Sarbanes technical audit guidance, the PCAOB has made it clear that detecting fraud must be the focus of the audit process. Consider that “fraud” was mentioned on 76 different occasions in PCAOB Auditing Standard No. 2.

Of course, if designed and operating effectively, a company’s internal control system should prevent or detect fraud related to management’s assertions about the financial statements. As a result, it is absolutely essential for auditors to understand the relationship between a company’s internal control system and the financial statement assertions. In this spirit, the cases in this section are designed to provide a mechanism to illustrate the explicit linkage between an internal control activity and the financial statement assertion being supported using different examples of economic transaction activity.

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.

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Case 4.1

Enron: A Focus on Evidence—The Chewco Special Purpose Entity

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."[197] 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 $100 billion.[198] From 1996 to 2000, its revenues had increased by more than 750 percent and 65 percent per year, which was unprecedented in any industry.[199] 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 of obstruction of justice in connection with shredding documents related to 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.

Background

Enron was created in 1985 by the merger of two gas pipeline companies: Houston Natural Gas and InterNorth. Enron's mission was to become the leading natural-gas pipeline company in North America. As it adapted to changes in the natural gas industry, Enron changed its mission, expanding into natural gas trading and financing, and into other markets, such as electricity and other commodity markets.

In the process, Enron also made significant changes to several of its accounting procedures. For example, Enron began establishing several "special purpose entities" in many aspects of its business. A special purpose entity (SPE) is an entity—partnership, corporation, trust, or joint venture—created for a limited purpose, with limited activities and a limited life. A company forms an SPE so outside investors are assured they will only be exposed to the risk of the SPE and its particular purpose, such as building a gas pipeline, and not to the risks associated with the entire company. In addition, the SPE also protects the investment of outside investors by giving them control over its

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

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

[199] 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.

activities.

Conditions for Nonconsolidation of SPEs

A company is *not* required to consolidate the assets and liabilities of an SPE into those contained on its own balance sheet, and it may record gains and losses on transactions with an SPE, if two conditions are met:

1. An owner independent of the company must own a "substantive" equity interest (of at least 3 percent of the SPE's assets, and that 3 percent must remain at risk throughout the transaction), and
2. The independent owner must exercise control of the SPE.

The 3 percent minimum equity owned by outside investors was created in 1990 by EITF 90–15 and formalized by FASB Statements No. 125 and No. 140. This standard represented a major departure from typical consolidation rules, which generally required an entity to be consolidated if a company owned (directly or indirectly) 50 percent or more of the entity.[200] Consolidation rules for SPEs were also controversial because a company could potentially use an SPE for fraudulent purposes, such as keeping debt or nonperforming assets off its own consolidated balance sheet.

JEDI and Chewco

In 1993 Enron and the California Public Employees Retirement System (CalPERS) formed an SPE, a $500 million 50–50 partnership they called Joint Energy Development Investments Limited (JEDI).[201] Enron was not required to consolidate the partnership within Enron's financial statements because it did not own more than 50 percent of the venture.

In 1997, Enron offered to buy out CalPERS's interest in JEDI. To maintain JEDI as an unconsolidated entity, Enron needed to identity a new limited partner. Enron's CFO Andrew Fastow proposed that Enron form another SPE, named Chewco Investments (after *Star Wars* character Chewbacca), the bulk of whose equity investment would

[200] Bala G. Dharan, "Enron's Accounting Issues—What Can We Learn to Prevent Future Enrons," Prepared Testimony Presented to the U.S. House Energy and Commerce Committee's Hearings on Enron Accounting, February 6, 2002, pp. 11–12.

[201] JEDI was also a sly nod to the *Star Wars* films; CFO Andy Fastow, who devised the partnership, was a *Star Wars* fan.

come from third-party investors, to buy out CalPERS's JEDI interest.[202]

Chewco's Capital Structure

Unsuccessful in obtaining outside equity, Enron created a capital structure for Chewco that had three elements:

1. $240 million unsecured subordinated loan to Chewco from Barclays Bank (Enron would guarantee the loan);
2. $132 million advance from JEDI to Chewco under a revolving credit agreement; and
3. $11.5 million in equity (representing approximately 3 percent of total capital) from Chewco's general and limited partners.[203]

Chewco's Partners

Michael Kopper, an Enron employee who reported to CFO Fastow, was the general partner of Chewco. The limited partner of Chewco was an entity called Big River Funding LLC, whose sole member was an entity named Little River Funding LLC. Kopper had invested $115,000 in Big River and $10,000 in Little River but transferred these investments to William Dodson (who allegedly may have been Kopper's domestic partner). As such, Kopper technically had no ownership interest in Chewco's limited partner. The remaining $11.4 million was provided by Barclays Bank in the form of "equity loans" to Big River and Little River.

Barclays required Big River and Little River to establish cash reserve accounts of $6.6 million and that the reserve accounts be fully pledged to secure repayment of the $11.4 million. JEDI, of which Enron still owned 50 percent, made a special $16.6 million distribution to Chewco, out of which $6.6 million could be used to fund the cash reserve accounts.[204] (See Figure 4.1.1 for a visual depiction of the Chewco transaction.)

Andersen's Audit of the Chewco Transaction

Enron's auditor Arthur Andersen requested that Enron provide all of the documentation in its possession relating to

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[202] William C. Powers, Jr., Raymond S. Troubh, Herbert S. Winokur, Jr, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp*., February 1, 2002, p. 43.

[203] William C. Powers, Jr., Raymond S. Troubh, Herbert S. Winokur, Jr, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp*., February 1, 2002, p. 49.

[204] William C. Powers, Jr., Raymond S. Troubh, Herbert S. Winokur, Jr, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp*., February 1, 2002, pp. 48–51.

the Chewco transaction. In its audit of the transaction, Andersen allegedly reviewed the following:[205]

- The minutes of Enron's Executive Committee of the Board of Directors approving the transaction
- The $132 million loan agreement between JEDI and Chewco
- Enron's guarantee agreement of a $240 million from Barclays to Chewco
- An amended JEDI partnership agreement
- A representation letter from Enron and a representation letter from JEDI, each of which stated that the related party transactions had been disclosed, and all financial records and related data had been made available to Andersen.

Andersen received confirmation regarding the loan agreement from a Chewco representative. Andersen also requested that Enron provide documents relating to Chewco's formation and structure. However, Enron allegedly told Andersen that it did not have these documents and could not obtain them because Chewco was a third party with its own legal counsel and ownership independent of Enron.[206] Andersen allegedly accepted this explanation and only relied on the evidence it had been given.

When the Chewco transaction was reviewed closely in late October and early November 2001, Enron and Andersen concluded that Chewco was an SPE without sufficient outside equity and that it should have been consolidated into Enron's financial statements. The retroactive consolidation of Chewco and the investment partnership in which Chewco was a limited partner decreased Enron's reported net income by $28 million (out of $105 million total) in 1997, by $133 million (out of $703 million total) in 1998, by $153 million (out of $893 million total) in 1999, and by $91 million (out of $979 million total) in 2000. It also increased Enron's reported debt by $711 million in 1997, by $561 million in 1998, by $685 million in 1999, and by $628 million in 2000.[207]

Case Questions

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[205] Thomas H. Bauer, Prepared Witness Testimony at Subcommittee on Oversight and Investigations related to "Financial Collapse of Enron Corp," February 7, 2002.

[206] Thomas H. Bauer, Prepared Witness Testimony at Subcommittee on Oversight and Investigations related to "Financial Collapse of Enron Corp," February 7, 2002.

[207] William C. Powers, Jr., Raymond S. Troubh, Herbert S. Winokur, Jr, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp*., February 1, 2002, p. 42.

1. Please consult the key provisions of Emerging Issues Task Force (EITF) 90-15. How did Enron's Chewco SPE fail to meet the outside equity requirement for nonconsolidation? Did Enron meet the "control" requirement for nonconsolidation?
2. Based on your understanding of the audit evidence, did Arthur Andersen rely on sufficient and competent audit evidence in its audit of the Chewco transaction? Why or why not?
3. Please consult Section 401 of SOX. How would Section 401 apply on the Enron audit? Do you think that Section 401 would have improved the presentation of Enron's financial statements?
4. Consult Paragraph #60 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. What is the relevant financial statement assertion(s) about which of the financial statement account(s) related to the Chewco transaction? Please provide adequate support for your answer.

FIGURE 4.1.1 Chewco Transaction