**Arthur Andersen and the Enron Case**

The firm Arthur Andersen audited the financial statements of Enron (and gave it an unqualified opinion) for each year of its existence, from 1985 through 2000. In the wake of the Enron scandal, investors, regulators, and the public desired answers to three questions with respect to Arthur Andersen and Enron:

- Did Arthur Andersen’s audit team know about Enron’s controversial accounting issues, particularly the special-purpose entities (SPEs)?
- Did Arthur Andersen employees help Enron set up these SPEs?
- Why did employees of Arthur Andersen shred Enron-related documents?

**Did Arthur Andersen Know?** Yes. For example, on February 5, 2001, partners of Arthur Andersen met to discuss Enron. The partners were concerned about the Enron SPEs, particularly the active involvement of Enron’s CFO in the SPEs. The partners agreed that their concerns should be shared with Enron’s board of directors. A board meeting was held the next week (on February 12), with representatives of Andersen in attendance, but the minutes do not indicate that they shared any of the SPE concerns. In fairness to Andersen, notwithstanding its shocked protestations to the contrary, many parties outside Enron had known of these SPEs for years. In particular, a number of Wall Street investment firms were investors in these SPEs (along with Enron’s CFO) and thus had inside information about how the SPEs were structured. These investment firms included GE Capital, J.P. Morgan Capital, Merrill Lynch, and Morgan Stanley.

**Did Arthur Andersen Help?** Yes. The following comes from an internal Enron investigation conducted in early 2002: “From 1997 to 2001, Enron paid Andersen $5.7 million in connection with work performed specifically on the LJM and Chewco transactions.” The LJM and Chewco transactions were the most prominent of the SPEs involved in the Enron accounting scandal. Again, out of fairness to Arthur Andersen, it should be noted that advisory work on difficult accounting issues is a service that all accounting firms have been providing to their clients for years. This is a valuable service because it allows all U.S. companies to take advantage of the technical expertise developed by the large audit firms.

**Why Did Andersen Shred?** The shredding was in compliance with Andersen’s existing document policy, which allowed and even encouraged the disposal of all peripheral documents not forming part of the formal audit workpapers. This policy was consistent with the practice of the other large audit firms, reflecting the impossibility of keeping every draft memo, email message, and to-do list generated as part of a complex audit. Andersen’s document policy also stated that, when Andersen was served a subpoena with respect to a certain audit engagement, no further documents or files could be disposed of. In the case of Enron, this two-faceted document policy was followed to the letter by Arthur Andersen—the shredding began in earnest on October 23, 2001, apparently in response to news of an SEC investigation of Enron’s accounting practices, and the shredding stopped on November 9, one day after Andersen received a subpoena for its
Enron-related documents. In retrospect, the document shredding undertaken by Andersen employees was a $10 billion mistake. Without the sleazy image of cover-up conveyed by the news that Andersen employees had shredded at least 50 trunks and boxes of documents, Andersen would probably have escaped the Enron debacle with just a harsh reprimand from the SEC and, probably, a large settlement payment (around $1 billion) to Enron shareholders. Instead, the document shredding led to Andersen’s indictment on obstruction of justice charges, and the subsequent loss of credibility caused a rapid exodus of Andersen’s clients, blasting the prospects of a venerable accounting partnership that had previously had an aggregate value to the partners almost surely in excess of $10 billion.

Questions:
1. Should auditors be barred from doing any type of consulting for audit clients? Explain.
2. At its peak, Enron’s stock was worth about $65 billion. Consider the following parties and decide for what fraction of that $65 billion loss in value each is responsible: Enron’s management, Enron’s board of directors, Arthur Andersen, the financial analyst community, and the investors themselves.

Sources:
Email message from Nancy A. Temple to Michael C. Odom; subject: Document retention policy, October 12, 2001.

QUALIFIED AUDIT OPINIONS IN CHINA

The need for external independent auditors arises because potential creditors and investors are naturally suspicious of the financial reports prepared by company managers. Managers have incentives to favorably bias the reported numbers such as to make it easier to get loans, to attract investors, and to increase their own bonuses and job advancement opportunities. An independent auditor increases the reliance that external users can place on the management-prepared financial statements.

Before the 1990s, there was no need for external auditors in China. When all companies in China were owned by the state and managed by central planners in Beijing, company financial statements were viewed as confidential government documents not available to outsiders. There was no need for independent external auditors because there were no external financial statement users. The economic reforms of the 1980s resulted in decentralization of the ownership of the Chinese state-owned enterprises (SOE). The demand for external audits of Chinese companies increased dramatically with the establishment of the Shanghai and Shenzhen Stock Exchanges, in 1990 and 1991, respectively.

In response to this demand for the independent certification of the financial statements of publicly traded companies, in 1995 the Chinese government adopted a more rigorous set of auditing standards to be followed by Chinese CPA firms. Before these standards were enacted,
qualified audit opinions were rare and were not publicly announced. The first publicly announced audit qualification under the new standards was published in the *Shanghai Securities Journal* on February 15, 1996. *(Note: In China, all listed companies are required to print their annual report and auditor’s opinion in one of seven designated newspapers.)* On this date, YANZHONG ENTERPRISES, a Shanghai-based conglomerate, revealed that its auditor, DA HUA CPA, had qualified the audit report for the 1995 financial statements. The reason for the qualification was that Yanzhong had misclassified investment gains and interest income as part of operating income and refused to revise the presentation. The reaction to this audit qualification was rapid and negative—the Da Hua CPA firm received many phone calls asking whether Yanzhong was on the verge of bankruptcy. Overall, for the ninety-six Chinese audit qualifications announced in 1996, 1997, and 1998, the average loss in company market value was 2% in the three days surrounding the qualification announcements.

**QUESTIONS:**
1. At the end of 1997, the Chinese government had authorized 105 CPA firms to audit the 740 listed companies. This is a large number of CPA firms competing for a small set of clients. What problems can be caused by this type of audit industry structure?
2. Exactly why would a company’s stock price decline upon announcement that the company’s financial statements have received a qualified audit opinion?

**SOURCE:**

**Who Hates the FASB?**

Some things in life are constant: Texans complain about the summer heat, Minnesotans complain about the winter cold, voters complain about Congress, and accountants and businesspeople complain about the FASB. In recent years, the FASB has been criticized for overly complex deferred tax accounting, market value accounting leading to more volatile earnings, postretirement benefit accounting that has significantly increased reported liabilities, and difficult stock option accounting that many users think is unnecessary.

Criticisms of the FASB fall under two general categories:

1. The standards are too theoretical and too costly to implement.
2. The standards negatively impact companies’ bottom lines.

The FASB has made a great effort to address the first concern. Proposed standards are often field-tested to ascertain how costly they will be to implement. Recent standards, such as *Statement No. 115*, which requires recording most securities at market value, have included explicit discussion of the expected costs and benefits of the standard. The Board also asks selected volunteer companies to field-test proposed standards to get an idea of how to minimize implementation costs. The Board views the standard-setting process as a balancing act—balancing the desire to make financial reporting technically and theoretically sound against the need to avoid overly radical and costly changes in the current system.

Although business executives often oppose FASB standards in public by voicing practicality concerns, privately they are more worried about the standards’ impact on reported performance. The 14,000-member Financial Executives Institute (FEI) has suggested that the FASB be abolished or that its staff and budget be cut and the body transformed into a part-time one. The
FEI complains that the FASB is too slow and that its rules do not leave enough room for professional judgment in reporting results.

The FASB must continue to carefully walk the fine line between theory and practice in order to avoid the fate of its predecessors, the APB and the CAP.

QUESTIONS:
1. What reasons might a company have for opposing a new accounting standard?
2. What factors favor entrusting the setting of accounting standards to the SEC? to the FASB?
3. What do you think should be the FASB’s most important consideration when setting accounting standards?

SOURCES:

PUBLIC ACCOUNTING AND LEGAL LIABILITY
In the early 1990s, the soaring cost of lawsuits threatened the financial viability of the public accounting profession. For example, during 1991, the then–Big 6 public accounting firms paid $477 million to settle and defend against lawsuits. This amount equaled 9% of total U.S. accounting and auditing revenues for these firms—and the amounts continued to climb. In November 1992, ERNST & YOUNG alone agreed to pay $400 million to settle claims that it had improperly audited a number of failed savings and loan institutions. As of August 1992, it was estimated that the public accounting profession faced a total of $30 billion in damage claims.

Critics of public accounting hailed these judgments. Stephen Gillers, a professor of legal ethics at New York University, said, “This represents a new magnitude of exposure for professional firms. Now maybe we’ll get auditors who audit.” Defenders of the profession suggested that the large judgments against auditors were not a sign of negligence but instead a sign that investors who had lost money were willing to bring suit against anyone with “deep pockets” to pay. These lawsuits were also encouraged by the mistaken public perception of an audit as a guarantee that the audited firm is solvent, well managed, and free of fraud.

Not surprisingly, as a result of these large judgments against auditors, audit fees increased sharply. Forty percent of CPA firms operated without legal liability insurance because the premiums had skyrocketed, tripling since 1985 for some firms. In addition, because of the liability risk, some companies found it difficult to hire a public accounting firm willing to perform an audit. Companies having particular difficulty finding an auditor were small banks and companies preparing to issue stock for the first time.

The auditing profession addressed this liability crisis with the following actions:
• Proportionate liability. Auditors have historically been found jointly and severally liable for losses suffered by investors. Joint and several liability means that if the auditor is found 1% responsible for a $100 million loss but those responsible for the other 99% (i.e., the failed company’s management and board of directors) are unable to pay, then the “deep pockets” auditor must come up with the whole $100 million. Proportionate liability would limit an auditor’s obligation to the appropriate share of the total loss. Congress passed a proportionate liability law, the Private Securities Litigation Reform Act, in 1995. Class action attorneys attempted to circumvent this act by bringing suit under state laws, but President Clinton closed this loophole in November 1998.
• **Trade-off with the federal authorities.** The bill granting auditors proportionate liability also imposed an increased responsibility on auditors to report fraud they discover in the course of an audit. Auditors opposed this provision because, they explained, audits are not designed specifically to detect fraud. Be that as it may, the law now requires auditors to ensure that any illegal acts they discover are reported to the SEC within one business day.

• **Quasi-limited liability.** In the past, most CPA firms were organized as partnerships. In an ordinary partnership, all of the partners are legally liable for the damages caused by the actions of one partner. An alternative—made available in all U.S. states in 1994—is to organize as a limited liability partnership (LLP). In an LLP, each partner has unlimited liability for the general debts of the business but is not responsible for legal liabilities associated with the negligent actions of other partners. All of the Big 5, and many other CPA firms, have organized as LLPS. Whether this business structure will insulate all partners from the liabilities created by the actions of a few will be tested in the courts in the lawsuits Arthur Andersen will face in the Enron case.

**QUESTIONS:**
1. The public mistakenly perceives an audit as a guarantee that the audited firm is solvent, well managed, and free of fraud. What assurance is actually given by an unqualified audit opinion?
2. Why might an audit firm shy away from auditing a small bank or a company preparing to issue stock for the first time?
3. As an investor, would you place more reliance on financial statements audited by a firm organized as an ordinary partnership or as an LLP? Why?

**SOURCES:**