

### **Initiation of the Enron/Andersen scandal**

On October 16<sup>th</sup> 2001 Enron Corp. (Enron), which was the seventh largest corporation in the United States, publicly announced a shocking 2001 third quarter net loss of \$618 million. This sudden downturn in earnings along with the unofficial disclosure by Enron that it would shrink shareholder equity by \$1.2 billion contributed to a disastrous drop in the price of Enron shares.

Over the past decade, Enron was a major natural gas provider, a trader of electricity and had retail energy operations on a wide scale. Given Enron's major influence in the energy industry, which naturally dictated a prominent presence in the publicly traded securities markets, its unexpected collapse prompted the Securities and Exchange Commission (SEC) to initiate an investigation on October 17<sup>th</sup> that asked for a written explanation by Enron.

The direct concern of the SEC in the Enron collapse meant that it had reason to believe that Enron was engaged in creative accounting. This reasoning is corroborated by the fact that the SEC requires all corporations listed on the major exchanges to annually file audited financial statements, which demonstrates the SEC's objective in enforcing the issuance of financial statements that are fairly stated in all material respects, in accordance with Generally Accepted Accounting Principles (GAAP).

The SEC's inquiry into Enron made the United States District Court (USDC) put Enron's external auditor, Arthur Andersen, LLP (Andersen), under the microscope. Andersen was soon found to have violated the Code of Professional Conduct set by the American Institute of Certified Public Accountants (AICPA) and committed a criminal act according to the USDC.

### **Violations of the Code of Professional Conduct by Andersen**

Andersen was one of the “Big Five” accounting firms in the United States, which had accepted to adhere to the Code of Professional Conduct (Code) set by the AICPA. True violations of the Code come about when the Accounting/CPA firm breaks any of the Rules of Conduct, which are part of the Code. The Rules of Conduct “establish minimum standards of acceptable conduct in the performance of professional services”, such as the performance of audits in the case of Enron. Andersen was unfortunately negligent of many of the Rules of Conduct according to the USDC. The following claims made by the USDC about Andersen signify major breaches of some of the Rules of Conduct.

- The October 16<sup>th</sup> announcement by Enron of its major losses exposed the two most obvious unprofessional acts committed by Andersen to the eyes of the general public. Enron’s income statement had several non-recurring charges to income, which were clearly improper classifications. The USDC claimed that these charges were a result of prior inappropriate classifications of hundreds of millions of dollars as increases to Enron’s stockholder’s equity. Although Andersen had complete knowledge of these fraudulent financial reporting actions, it affirmatively stated that Enron’s financial statements were in conformity with GAAP. This action by Andersen is unmistakably inconsistent with “Rule 203-Accounting Principles”.

The second obvious unprofessional act committed by Andersen is the subordination of its professional judgment to Enron’s management. Andersen disagreed with Enron’s management on the improper classification of the non-recurring charges to income, but did not consider rectifying the situation by direct resolution or by reporting to Enron’s

audit committee, which is in absolute disagreement with “Rule 102-Integrity and Objectivity”.

- Andersen’s intentional expression of a faulty opinion on Enron’s financial statements and the subordination of its judgment to Enron’s management were the repercussions of its breach of “Rule 201-General Standards”. Andersen disregarded Rule 201 in two ways, which are discussed in the following paragraphs.

Due to the importance that Andersen placed on Enron, Andersen situated an Andersen team in Enron’s “principal place of business”, Houston, Texas, that had the duty of engaging in audit tasks for Enron. The assigned Andersen team reached a stage where it implicitly considered itself an autonomous entity that used its own discretion in making tuff decisions. An Enron employee who was a former Andersen employee, Sherron Watkins, noticed Enron’s usage of “special purpose entities”, which fraudulently enhanced Enron’s financial position. The Andersen team had irresponsibly advised Enron to use this illegal act in the spring of 2001, which is in utter disagreement with Andersen’s professional accounting methodology. Therefore, the Andersen team was inadequately supervised by Andersen, which is contravening to the “planning and supervision” section of Rule 201.

The highly unprofessional conduct of the Andersen team in auditing Enron was by no means a surprise to Andersen’s senior management. This stems from the fact that the senior management had rated the Andersen team as a two out of five in the year 2000, implying a devastatingly low 40% in the team’s professional competence level. Unfortunately, no steps were taken to cure the situation leading to yet another breach of Rule 201, which has as its first section an item entitled “professional competence”.

### **The Andersen Indictment and “Rule 501-Acts Discreditable”**

Enron communicated the October 17th 2001 SEC requisition of a written explanation to the Andersen team on October 19<sup>th</sup>, which initiated an Andersen high-level management meeting. However, Andersen had been on high alert since October 9<sup>th</sup> 2001 through contracting a major law firm in anticipation for “Enron-related litigation”. On October 23<sup>rd</sup>, one day after a meeting of Andersen partners and Enron, Andersen decided to engage in “a wholesale destruction of documents at Andersen’s offices in Houston, Texas”, preventing its unprofessional acts from being unveiled in the process.

Andersen went as far as calling on all of its personnel who are either located in national or international branches to destroy and shred all Enron related documents along with any soft-copies or electronic information that had anything to do with Enron. By way of deception, Andersen called for a complete cessation of the wholesale destruction of Enron documents once the “SEC served Andersen with the anticipated subpoena relating to its work for Enron”, because it had been “officially served” for the Enron documents.

Andersen has not only contravened the AICPA’s Rules of Conduct, but it has also committed dishonorable actions in trying to find loopholes to save itself from being convicted of an involvement in fraudulent financial reporting. Therefore, the USDC has indicted Andersen with the crime of “obstruction of justice” and has been completely discredited by the accounting profession. In fact, the charge of the USDC against Andersen has put the 89-year-old auditing firm in violation of “Rule 501-Acts Discreditable”, which explicitly states that a “member shall not commit an act discreditable to the profession”.

### **Andersen's devastation and "Rule 101-Independence"**

Andersen is on the verge of destruction because of the criminal charges it faces. Its guilt is an absolute certainty and its credibility is history as far as the AICPA is concerned. So why has Andersen put itself in such an irreversibly adverse position? Of course the reason for most white-collar crimes has always been "greed", but it is our interest as auditors to discover what has skewed Andersen to subconsciously assume that the AICPA's Rules of Conduct do not even exist. The answer is not clear-cut, but a possible explanation is provided in the following paragraphs.

Companies have always been under pressure to keep the prices of their stock at a reasonably high number in order for them to be perceived as lucrative investments. Obviously the management of a company would have to report higher earnings, a good financial position and cash flow for this to materialize, but the market cannot trust such assertions without the SEC's mandatory independent audits of them. Hence, the interests of stakeholders, especially investors, are not compromised because of the independence audit firms enjoy. However, auditing firms are also in the business of making profits and what they make from conducting independent audits is diminutive when compared to the fees they charge for Management Consulting Services (MCSs).

In 2000 alone, MCSs provided by Andersen to Enron were worth \$50 million, which sheds light on the possibility that Andersen would be willing to commit and conceal unprofessional acts in order to retain the Enron account. In principal, this logic was refuted by the AICPA under the argument that there are prescribed MCSs under "Rule 101-Independence" which do not impair independence in addition to the legal barriers preventing companies from shopping for auditor opinion. However, the words of the former chairman of the SEC, Arthur Levitt, denote that "auditors must be

independent of their clients, and consulting enmeshed them in their client's business in ways detrimental to that independence". It is imperative to know that the AICPA has indeed provided the auditing profession with the necessary guidelines that insure their independence and hence their integrity, professionalism and good repute. However, the remarks of the former chairman of the SEC and the Andersen scandal, which damaged the image of the profession, must induce the AICPA to discover ways that prevent auditing firms from using MCSs as tools to conceal any fraudulent acts.