Section 2

Understanding the Client's Business and Industry

To identify areas of elevated risk on the audit, an auditor must take great care to understand the client's business, industry, and, ultimately, their strategy to achieve competitive advantage in that industry. Because it can often be difficult for auditors to make the connection between a client's strategic direction and the identification of significant audit risks, the cases in this section are designed to provide a mechanism to illustrate the explicit linkage between a client's strategic direction and the identification of significant audit risks.

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 2.1

Enron: A Focus on Fraud and Inherent Risk Assessment

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."[72] 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.[73] From 1996 to 2000, Enron's revenues had increased by more than 750 percent (over 65 percent per year), which was

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

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

unprecedented in any industry.[74] 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.

Origins of Enron

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 several changes occurred in the natural gas industry in the mid-1980s, Enron adapted and changed its mission, expanding into natural gas trading and financing, as well as into other markets, such as electricity and other commodity markets.

Enron's First Few Years

In 1985, Enron had assets along the three major stages of the supply chain of natural gas: production, transmission, and distribution. Natural gas was "produced" from deposits found underground. The natural gas was transmitted via pipelines, or networks of underground pipes, either directly to industrial customers or sold to regional gas utilities, which then distributed it to smaller businesses and customers. Some companies in the industry had assets related to specific activities within the supply chain. For example, some companies owned pipelines, but did not produce their own gas. These companies often entered into long-term "take or pay" contracts, whereby they paid for minimum volumes in the future at prearranged prices, to protect against supply shortages.

In early 1986, Enron reported a loss of $14 million for its first year. As a result, the company employed a series of cost-cutting measures, including layoffs and pay freezes for top executives. Enron also started selling off assets to reduce its debt. Nevertheless, Enron's financial situation was still bleak in 1987. That year, Moody's downgraded its

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[74] 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.

credit rating to "junk bond" status.[75]

Impact of Significant Industry Change on Enron

Enron faced significant change in its industry environment due to the government's decision in the mid-1980s to deregulate the once highly regulated industry. The government, which had dictated the price pipeline companies paid for gas and the price they could charge their customers, decided to allow the market forces of supply and demand to dictate prices and volumes sold. As part of this process, the government required that pipeline companies provide "open access" to their pipelines to other companies wanting to transport natural gas, so that pipeline companies would not have an unfair competitive advantage.[76]

Enron's Natural Gas Pipeline Business

Enron adapted by providing "open access" to its pipelines, i.e., charging other firms for the right to use them. Enron also took advantage of the ability to gain "open access" to pipelines owned by other companies. For example, in 1988, Enron signed a 15-year contract with Brooklyn Union to supply gas to a plant being built in New York. Because Brooklyn Union was not connected to Enron's pipeline system, Enron needed to contract with another pipeline company to transport the gas to Brooklyn Union. Enron was, therefore, assuming added risks related to the transportation of the gas. The long-term nature of the contract was also risky because prices could rise to a level that would make the contract unprofitable.[77]

Enron Expands into Natural Gas Trading and Financing

Enron capitalized on the introduction of market forces into the industry by becoming involved in natural gas trading and financing. Enron served as an intermediary between producers who contracted to sell their gas to Enron and gas customers who contracted to purchase gas from Enron. Enron collected as profits the difference between the prices at

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[75] 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. 14.

[76] Paul M. Healy and Krishna Palepu, "Governance and Intermediation Problems in Capital Markets: Evidence from the Fall of Enron," Harvard NOM Research Paper No. 02–27, August 2002, p. 7.

[77] 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. 34.

which it sold the gas less the prices at which it purchased the gas. Enron's physical market presence (i.e., owning the pipelines and charging a price for distribution that was proportional to the spot price of gas it might purchase) helped to mitigate the risk of a price increase of the gas it was purchasing.[78]

In response to the problem of getting producers to sign long-term contracts to supply gas, Enron started giving such producers cash up-front instead of the payment over the life of the contract. Enron then allowed for the natural gas contracts it devised—which were quite complex and variable, depending on different pricing, capacity, and transportation parameters—to be traded.

Enron Expands beyond Natural Gas

Enron decided to apply its gas-trading model to other markets, branching out into electricity and other commodity markets, such as paper and chemicals. To accomplish its expansion strategy, it sought to pursue an "asset light" strategy. Enron's goal was to achieve the advantages of having a presence in the physical market, without the disadvantages of huge fixed capital expenditures. For example, in natural gas, Enron divested its assets related to pumping gas at the wellhead or to selling gas to customers, and then set out to acquire assets related to midstream activities, such as transportation, storage, and distribution.[79] By late 2000, Enron owned 5,000 fewer miles of natural gas pipeline than when founded in 1985; in fact, Enron's gas transactions represented 20 times its existing pipeline capacity.[80]

In addition, Enron undertook international projects involving the construction and management of energy facilities outside the United States—in the United Kingdom, Eastern Europe, Africa, the Middle East, India, China, and Central and South America. Established in 1993, the Enron International Division did not adhere to the asset-light strategy pursued by other divisions. Enron also expanded aggressively into broadband, the use of fiber optics to transmit audio and video. Among its goals in that business were to deploy the largest open global broadband network

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[78] Christopher L. Culp and Steve H. Hanke, "Empire of the Sun: An Economic Interpretation of Enron's Energy Business," *Policy Analysis,* No. 470, February 20, 2003, p. 6.

[79] Christopher L. Culp and Steve H. Hanke, "Empire of the Sun: An Economic Interpretation of Enron's Energy Business," *Policy Analysis,* No. 470, February 20, 2003, p. 7.

[80] Paul M. Healy and Krishna Palepu, "Governance and Intermediation Problems in Capital Markets: Evidence from the Fall of Enron," Harvard NOM Research Paper No. 02–27, August 2002, pp. 9–10.

in the world.[81]

Case Questions

1. Based on your understanding of inherent risk assessment, please identify three specific factors about Enron's business model in the late 1990s that are likely to impact your audit procedures if you were conducting an audit of the financial statements at Enron.
2. Please consult Q39 and Q43 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of the inherent risks identified at Enron (in Question #1) would influence the nature, timing, and extent of your audit work at Enron.
3. Please consult Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Consider how the change in industry regulation and Enron's resulting strategy shift would impact your inherent risk assessment for the relevant financial statement assertions about the revenue account. Specifically, please explain why your understanding of Enron's strategy impacts such inherent risk assessment.
4. Consult Paragraph #24 of PCAOB Auditing Standard No. 2 and SAS No. 99. Please brainstorm about how a revenue recognition fraud might occur under Enron's strategy in the late 1990s. Can you think of a control procedure that would prevent, detect, or deter such a fraud?

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[81] Christopher L. Culp and Steve H. Hanke, "Empire of the Sun: An Economic Interpretation of Enron's Energy Business," *Policy Analysis,* No. 470, February 20, 2003, p. 4.