Appendix

Company Cases

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 A.1

Enron

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."[302] 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.[303] From 1996 to 2000, Enron's revenues had increased by more than 750 percent and 65 percent per year, which was unprecedented in any industry.[304] Yet, just a year later, Enron filed for bankruptcy, and billions of shareholder dollars and retirement savings were lost.

Enron's auditor during this period was Arthur Andersen, LLP. Andersen was one of the five largest international

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

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

[304] 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.

public accounting firms and 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.

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 the gas 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 credit rating to "junk bond" status.[305]

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 prices pipeline companies paid for gas and the prices 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

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[305] 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.

companies would not have an unfair competitive advantage.[306]

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. It 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.[307]

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 among 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 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 mitigate the risk of a price increase of the gas it was purchasing.[308]

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.

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[306] 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.

[307] 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.

[308] 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.

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, Enron sought to pursue an "asset light" strategy. Enron's goal was to achieve the advantages of 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.[309] By late 2000, Enron owned 5,000 fewer miles of natural gas pipeline than when founded in 1985; in fact, its gas transactions represented 20 times its existing pipeline capacity.[310]

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 in the world.[311]

Enron's Changes to Accounting Procedures

As a result of its change in business strategy, Enron 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 that they will only be exposed to the risk of the SPE and its particular purpose, such as building a gas pipeline, and not the risks

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[309] 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.

[310] 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.

[311] 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.

associated with the entire company. In addition, the SPE also protects the investment of outside investors by giving them control over its activities. If an SPE satisfies certain conditions, it does not have to be consolidated with the sponsoring company.

Conditions for Nonconsolidation of SPEs

A company is *not* required to consolidate the asset and liabilities of the SPE into those contained on its own balance sheet, and it may record gains and losses on transactions with the 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 Statement No.'s 125 and 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.[312] Consolidation rules for SPEs were also controversial because a company could potentially use an SPE for fraudulent purposes, such as "hiding" debt or nonperforming assets by keeping these items 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).[313] 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' interest in JEDI. To maintain JEDI as an unconsolidated entity,

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[312] 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.

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

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 come from third-party investors, to buy out CalPERS's JEDI interest.[314]

Chewco's Capital Structure

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

1. $250 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.[315]

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 called 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.[316] Please refer to Figure 4.1.1 in Section 4, on page 114, for a visual depiction of the Chewco

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[314] 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.

[315] 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.

[316] 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.

transaction.

Andersen's Audit of the Chewco Transaction

Enron's auditor Arthur Andersen requested that Enron provide all the documentation in its possession relating to the Chewco transaction. In its audit of the transaction, Andersen reviewed the following:[317]

- 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 related party transactions had been disclosed and that 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 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.[318] 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

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

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

$711 million in 1997, by $561 million in 1998, by $685 million in 1999, and by $628 million in 2000.[319]

Enron's Use of Mark-to-Market Accounting

Enron also lobbied the SEC about the use of mark-to-market (MTM) accounting for its trading business, which allowed for the present value (rather than the "actual value," which was used in its original natural gas business) of the stream of future inflows and expenses under a contract to be recognized as revenues and expenses, respectively, once the contract was signed.

In 1992, the SEC's chief accountant, Walter Scheutz, granted Enron permission to use MTM during the first quarter of its fiscal year ended December 31, 1992. However, he also said that MTM could be used *only* in Enron's natural gas trading business.[320] Enron's chief financial officer, Jack Tompkin, wrote back to Scheutz informing him that "Enron has changed its method of accounting for its energy-related, price-risk management activities effective January 1, 1991 … the cumulative effect of initial adoption of mark-to-market accounting, as well as the impact on 1991 earnings is not material."[321] Enron was the first company outside the financial services industry to use MTM accounting.[322]

While the value of stock portfolios varied directly with changes in stock prices, the value of natural gas contracts were harder to assess. They often required complex valuation formulas with multiple assumptions for the formulas' variables, such as interest rates, customers, costs, and prices. These assumptions have a major impact on value and are related to long time periods, in some cases, as long as 20 years.

Early Application of MTM Accounting: Sithe Energies Agreement

One of the earliest contracts for which Enron employed MTM accounting was an agreement for Enron to supply

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[319] 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.

[320] Robert Bryce, *Pipe Dreams: Greed, Ego, and the Death of Enron* (New York: Perseus Book Group, 2002), p. 67.

[321] Robert Bryce, *Pipe Dreams: Greed, Ego, and the Death of Enron* (New York: Perseus Book Group, 2002), p. 67.

[322] 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), pp. 7–11.

Sithe Energies with 195 million cubic feet of gas per day for 20 years for a plant that Sithe was planning to build in New York. The estimated value of the gas to be supplied was $3.5 to $4 billion. Using MTM, Enron was able to book profits from the contract even before the plant started operating.[323]

Before MTM, it would have recognized the *actual* costs of supplying the gas and *actual* revenues received from selling the gas in each time period. Using MTM meant that as soon as a long-term contract was signed, the *present value* of the stream of future inflows under the contract was recognized as revenues and the *present value* of the expected costs of fulfilling the contract were expensed.[324] Changes in value were recognized as additional income or losses (with corresponding changes to the relevant balance sheet accounts) in subsequent periods.[325]

Enron's Expanded Use of MTM Accounting

Although the SEC had initially given approval for Enron to use MTM in the accounting of natural gas futures contracts, Enron quietly began using MTM for electric power contracts and trades as well.[326] In one example, Enron signed a 15-year $1.3 billion contract to supply electricity to Eli Lilly. Enron calculated the present value of the contract as more than half a billion dollars and recognized this amount as revenue. It also reported estimates for the costs associated with servicing the contract. At the time, Indiana had not yet deregulated electricity. Thus, Enron needed to predict when Indiana would deregulate, as well as the impact of the deregulation on the costs related to the

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[323] Bethany McLean and Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (New York: Penguin Group, 2003), pp. 60–61.

[324] Bala G. Dharan and William R. Bufkins, "Red Flags in Enron's Reporting of Revenues and Key Financial Measures," March 2003, pre-publication draft (http://www.ruf.rice.edu/~bala/files/dharan-bufkins_enron_red_flags_041003.pdf), pp. 7–11.

[325] 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. 39.

[326] 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. 127.

deal.[327]

Enron also extended MTM accounting to other businesses. In another example, Enron signed a 20-year agreement with Blockbuster Video in July 2000 to introduce entertainment on-demand. Enron set up pilot projects in Portland, Seattle, and Salt Lake City to store the entertainment and distribute it over its broadband network. Based on these pilot projects, Enron recognized estimated profits of more than $110 million for the Blockbuster deal. Technical viability and market demand were difficult to predict in these initial stages.[328] Canceled in March 2001, the Blockbuster deal never reached past the pilot stage, yet significant profits were recognized by Enron on the deal.

Enron's Relationship with Auditor Arthur Andersen

Enron paid Arthur Andersen $46.8 million in fees for auditing, business consulting, and tax work for the fiscal year ended August 31, 1999; $58 million in 2000; and more than $50 million in 2001.[329] Andersen was collecting a million dollars a week from Enron in the year before Enron's cash. It was one of Andersen's largest clients.

More than half of that amount was for fees that were charged for nonaudit services.[330] In 2000, for example, Enron paid Andersen $25 million for audit services and $27 million for consulting and other services, such as internal audit services.[331]

Andersen had performed Enron's internal audit function since 1993. That year, Andersen had hired 40 Enron personnel, including the vice president of internal audit, to be part of Andersen's team providing internal audit

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[327] Paul M. Healy and Krishna Palepu, "The Fall of Enron," *Journal of Economic Perspectives*, Vol. 17, No. 2, Spring 2003, p. 10.

[328] Paul M. Healy and Krishna Palepu, "The Fall of Enron," *Journal of Economic Perspectives,* Vol. 17, No. 2, Spring 2003, p. 10.

[329] Anita Raghavan, "Accountable: How a Bright Star at Andersen Fell Along with Enron," *The Wall Street Journal,* May 15, 2002. Accessed from Factiva (February 25, 2005).

[330] Jane Mayer, "The Accountants' War," *New Yorker,* April 22, 2002. Accessed from LexisNexis Academic (February 25, 2005).

[331] Nanette Byrnes, "Accounting in Crisis," *BusinessWeek,* January 28, 2002. Accessed from LexisNexis Academic (February 25, 2005).

services.[332] In 2000, as SEC chairman Arthur Levitt was trying to reform the industry practice of an audit firm also offering consulting services to their audit clients, Enron's Chairman and CEO Ken Lay sent a letter to Levitt (the letter was secretly coauthored by Andersen partner David Duncan), in which he wrote:

> While the agreement Enron has with its independent auditors displaces a significant portion of the activities previously performed by internal resources, it is structured to ensure that Enron management maintains appropriate audit plan design, results assessment, and overall monitoring and oversight responsibilities … Enron has found its "integrated audit" arrangement to be more efficient and cost-effective than the more traditional roles of separate internal and external auditing functions.[333]

At Andersen, an audit partner's individual compensation depended on his or her ability to sell other services (in addition to auditing) to clients.[334] Therefore, the nonaudit services provided to Enron had a big impact on the salary of the lead Andersen partner on the Enron engagement, David Duncan, who was earning around $1 million a year.[335] After graduating from Texas A&M University, Duncan joined Andersen in 1981, made partner in 1995, and was named the lead partner for Enron two years later. Duncan developed a close personal relationship with Enron's Chief Accounting Officer (CAO) Richard Causey, who himself had worked at Arthur Andersen for almost nine years. Duncan and Causey often went to lunch together, and their families had even taken vacations together.[336]

Causey, who came to Enron in 1991, was appointed CAO in 1997. Causey was responsible for recruiting many

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[332] Thaddeus Herrick and Alexei Barrionuevo, "Were Auditor and Client Too Close-Knit?" *Wall Street Journal*, January 21, 2002. Accessed from ProQuest Research Library (February 26, 2005).

[333] "Letter from Kenneth Lay," Bigger than Enron transcript, *Frontline,* Aired on Public Broadcasting Service on June 20, 2002 (www.pbs.org/wgbh/pages/frontline/shows/regulation/congress/lay.html).

[334] Jane Mayer, "The Accountants' War," *New Yorker,* April 22, 2002. Accessed from LexisNexis Academic (February 25, 2005).

[335] Bethany McLean and Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (New York: Penguin Group, 2003), pp. 146–147.

[336] Susan E. Squires, Cynthia J. Smith, Lorna McDougal, and William R. Yeack, *Inside Arthur Andersen* (Upper Saddle River, NJ: Prentice Hall, 2003), p. 2.

Andersen alumni to work at Enron. Over the years, Enron hired at least 86 Andersen accountants.[337] Several were in senior executive positions, including Jeffrey McMahon, who had served as Enron's treasurer and president, and Vice President Sherron Watkins.

Although Andersen had separate offices in downtown Houston, Duncan and up to one hundred Andersen managers had a whole floor available to them within Enron's headquarters in Houston.[338] Duncan once remarked that he liked having the office space there because it "enhanced our ability to serve" and to "generate additional work."[339] Andersen boasted about the closeness of their relationship in a promotional video. "We basically do the same types of things.… We're trying to kinda cross lines and trying to, you know, become more of just a business person here at Enron," said one accountant. Another spoke about the advantage of being located in Enron's building: "Being here full-time year-round day-to-day gives us a chance to chase the deals with them and participate in the deal making process…."[340]

In fact, Andersen and Enron employees went on ski trips and took annual golf vacations together. They played fantasy football against each other on their office computers and took turns buying each other margaritas at a local Mexican restaurant chain. One former senior audit manager at Andersen said that it was "like these bright geeks at Andersen suddenly got invited to this really cool, macho frat party."[341]

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

[337] 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. 145.

[338] Susan E. Squires, Cynthia J. Smith, Lorna McDougal, and William R. Yeack, *Inside Arthur Andersen* (Upper Saddle River, NJ: Prentice Hall, 2003), p. 126.

[339] Rebecca Smith and John R. Emshwiller, *24 Days: How Two Wall Street Journal Reporters Uncovered the Lies That Destroyed Faith in Corporate America* (New York: HarperBusiness, 2003), p. 289.

[340] Bethany McLean and Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (Penguin Group, 2003), p. 146.

[341] Flynn McRoberts, "Ties to Enron Blinded Andersen," *Chicago Tribune,* September 3, 2002. Accessed from Factiva (February 3, 2004).

Response

In 1999, Enron's CFO, 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 Professional Standards Group (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.[342]

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 Mr. Fastow obtain the approval of Enron's chief executive and its Board of Directors.[343]

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."[344] However, the memo

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[342] 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).

[343] 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).

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

Duncan's team prepared to document the deal indicated that Bass "concurred with our conclusions."[345]

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 SPE. All of the money here appears to be provided by Enron.… "[346] Duncan's team did not address Bass' 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.[347]

In February 2001, Andersen held a routine annual risk assessment meeting to determine whether to keep Enron as a client. Some partners raised concerns relating to how much debt Enron was *not* putting on its balance sheet, Fastow's conflict of interest, and the lack of disclosure in the company's financial footnotes.[348] 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 someone else 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

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

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

[347] 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).

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

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."[349] 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.[350]

Comprehensive List of Case Questions

1. What is auditor independence and what is its significance to the audit profession? What is the difference between independence in appearance and independence in fact?
2. Please consult Paragraph 32 of PCAOB Auditing Standard No. 2. In what ways, if any, was Arthur Andersen's independence in fact or in appearance potentially impacted on the Enron audit?
3. Refer to Section 201 of SOX. Please identify the services provided by Arthur Andersen that are no longer allowed to be performed. Do you believe that Section 201 was needed? Why or why not?
4. Please refer to Section 203 and Section 206 of SOX. How would these sections of the law have impacted the Enron audit? Do you believe that these sections were needed? Why or why not?
5. 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?
6. 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?
7. 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?
8. Please consult Section 203 of SOX. Do you believe that this provision of the law goes far enough, that is, do you

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

[350] 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).

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?

9. 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.
10. 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.
11. Please consult Paragraphs #68–70 of the 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.
12. 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?
13. 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?
14. 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?
15. 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?
16. 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.
17. Please consider the Sithe Energies contract described in the case. Does the use of MTM accounting violate the revenue recognition principle of GAAP? Why or why not?
18. Please refer to Paragraph #72 of PCAOB Auditing Standard No. 2. As an auditor, would you consider the

natural gas trading revenue recognized using MTM accounting as having a "differing level" of inherent risk than other types of revenue recognized by Enron? Why or why not?

19. Refer to Paragraph #74 of PCAOB Auditing Standard No. 2. Can you identify one point in the natural gas revenue recognition process where a member of Enron's management team might be able to perpetrate a fraudulent misstatement related to one of the relevant financial statement assertions? Please identify the assertion and use the case information to provide an example for your answer.
20. Please refer to Paragraphs #84–85 of PCAOB Auditing Standard No. 2. Identify one specific control activity that could be designed to prevent the misstatement (that you identified) from occurring. Next, identify one specific control procedure that could be designed to detect the misstatement (that you identified in Question #3) from occurring.