member of the Andersen firm with whom she had worked several years earlier. In an internal Andersen memorandum, that individual relayed Watkins' concerns to several colleagues, including the Enron audit engagement partner, David Duncan. At that point, Andersen officials in the firm's Chicago headquarters began systematically reviewing previous decisions made by the Enron's audit engagement team.

In fact, several months earlier, Andersen representatives had become aware of Enron's rapidly deteriorating financial condition and become deeply involved in helping the company's executives cope with that crisis. Andersen's efforts included assisting Enron officials in restructuring certain of the company's SPEs so that they could continue to qualify as unconsolidated entities. Subsequent press reports revealed that in February 2001, frustration over the aggressive nature of Enron's accounting and financial reporting decisions caused some Andersen officials to suggest dropping the company as an audit client.[21]

On December 12, 2001, Joseph Berardino testified before the Committee on Financial Services of the U.S. House of Representatives. Early in that testimony, Berardino freely admitted that members of the Enron audit engagement team had made one major error while analyzing a large SPE transaction that occurred in 1999. "We made a professional judgment about the appropriate accounting treatment that turned out to be wrong."[22] According to Berardino, when Andersen officials discovered this error in the fall of 2001, they promptly notified Enron's executives and told them to "correct it." Approximately 20 percent of the $600 million restatement of prior earnings announced by Enron on November 8, 2001, was due to this item.

The remaining 80 percent of the earnings restatement involved another SPE that Enron created in 1997. Unknown to Andersen auditors, one-half of that SPE's minimum 3 percent "external" equity had been effectively contributed by Enron. As a result, that entity did not qualify for SPE treatment, meaning that its financial data should have been included in Enron's consolidated financial statements from its inception. When Andersen auditors discovered this violation of the 3 percent rule in the fall of 2001, they immediately informed Enron's accounting staff. Andersen also informed the company's audit committee that the failure of Enron officials to reveal the source of the SPE's initial funding could possibly be construed as an illegal act under the Securities Exchange Act of 1934. Berardino implied that the client's lack of candor regarding this SPE exempted Andersen of responsibility for the resulting accounting and financial reporting errors linked to that entity.

Berardino also explained to Congress that Andersen auditors had been only minimally involved in the transactions that eventually resulted in the $1.2 billion reduction of owners' equity reported by Enron on October 16, 2001. The bulk of those transactions had occurred in early 2001. Andersen had not audited the 2001 quarterly financial statements that had been prepared following the initial recording of those transactions—public companies are not required to have their quarterly financial statements audited.

Berardino's testimony before Congress in December 2001 failed to appease Andersen's critics. Over the next several months, Berardino continually found himself defending Andersen against a growing torrent of accusations. Most of these accusations centered on three key issues. First, many critics raised the controversial and longstanding "scope of services" issue when criticizing Andersen's role in the Enron debacle. Over the final few decades of the twentieth century,

21. S. Labaton, "S.E.C. Leader Sees Outside Monitors for Auditing Firms," *The New York Times* (online), 18 January 2002.

22. J. Kahn and J. D. Glater, "Enron Auditor Raises Specter of Crime," *The New York Times* (online), 13 December 2001.

the major accounting firms had gradually extended the product line of professional services they offered to their major audit clients. A research study focusing on nearly 600 large companies that released financial statements in early 1999 revealed that for every $1 of audit fees those companies had paid their independent auditors, they had paid those firms $2.69 for nonaudit consulting services.[23] These services included a wide range of activities such as feasibility studies of various types, internal auditing, design of accounting systems, development of e-commerce initiatives, and a varied assortment of other information technology (IT) services.

In an interview with *The New York Times* in March 2002, Leonard Spacek's daughter revealed that her father had adamantly opposed accounting firms providing consulting services to their audit clients. "I remember him ranting and raving, saying Andersen couldn't consult and audit the same firms because it was a conflict of interest. Well, now I'm sure he's twirling in his grave saying, 'I told you so.'"[24] In the late 1990s, Arthur Levitt, the chairman of the SEC, had led a vigorous, one-man campaign to limit the scope of consulting services that accounting firms could provide to their audit clients. In particular, Levitt wanted to restrict the ability of accounting firms to provide IT and internal audit services to their audit clients. An extensive and costly lobbying campaign that the Big Five firms carried out in the press and among elected officials allowed those firms to defeat the bulk of Levitt's proposals.

Public reports that Andersen earned approximately $52 million in fees from Enron during 2000, only $25 million of which was directly linked to the 2000 audit, caused the scope of services issue to resurface. Critics charged that the enormous consulting fees accounting firms earned from their audit clients jeopardized those firms' independence. "It's obvious that Andersen helped Enron cook the books. Andersen's Houston office was pulling in $1 million a week from Enron—their objectivity went out the window."[25] These same critics reiterated an allegation that had widely circulated a few years earlier, namely, that the large accounting firms had resorted to using the independent audit function as "a loss leader, a way of getting in the door at a company to sell more profitable consulting contracts."[26] One former partner of a Big Five accounting firm provided anecdotal evidence corroborating that allegation. This individual revealed that he had been under constant pressure from his former firm to market various professional services to his audit clients. So relentless were his efforts that at one point a frustrated client executive asked him, "Are you my auditor or a salesperson?"[27]

A second source of criticism directed at Andersen stemmed from the firm's alleged central role in Enron's aggressive accounting and financial reporting treatments for its SPE-related transactions. The Powers Report released to the public in February 2002 spawned much of this criticism. That lengthy report examined in detail several of Enron's largest and most questionable SPE transactions. The Powers Report pointedly and repeatedly documented that Andersen personnel had been deeply involved in those transactions. Exhibit 3 contains a sample of selected excerpts from the Powers Report that refers to Andersen's role in "analyzing" and "reviewing" Enron's SPE transactions.

23. N. Byrnes, "Accounting in Crisis," *Business Week,* 28 January 2002, 46.

24. D. Barboza, "Where Pain of Arthur Andersen Is Personal," *The New York Times* (online), 13 March 2002.

25. *SmartPros.com*, "Lawsuit Seeks to Hold Andersen Accountable for Defrauding Enron Investors, Employees," 4 December 2001.

26. J. Kahn, "One Plus One Makes *What*?" *Fortune*, 7 January 2002, 89.

27. I. J. Dugan, "Before Enron, Greed Helped Sink the Respectability of Accounting," *The Wall Street Journal* (online), 14 March 2002.

EXHIBIT 3

SELECTED EXCERPTS FROM THE POWERS REPORT REGARDING ANDERSEN'S INVOLVEMENT IN KEY ACCOUNTING AND FINANCIAL REPORTING DECISIONS FOR ENRON'S SPE TRANSACTIONS

Page 5: In virtually all of the [SPE] transactions Enron's accounting treatment was determined with the extensive participation and structuring advice from Andersen, which reported to the Board.

Page 17: Various disclosures [regarding Enron's SPE transactions] were approved by one or more of Enron's outside [Andersen] auditors and its inside and outside counsel. However, these disclosures were obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships.

Page 24: The evidence available to us suggests that Andersen did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal controls over the related-party [SPE] transactions.

Page 24: Andersen participated in the structuring and accounting treatment of the Raptor transactions, and charged over $1 million for its services, yet it apparently failed to provide the objective accounting judgment that should have prevented these transactions from going forward.

Page 25: According to recent public disclosures, Andersen also failed to bring to the attention of Enron's Audit and Compliance Committee serious reservations Andersen partners voiced internally about the related-party transactions.

Page 25: The Board appears to have reasonably relied upon the professional judgment of Andersen concerning Enron's financial statements and the adequacy of controls for the related-party transactions. Our review indicates that Andersen failed to meet its responsibilities in both respects.

Page 100: Accountants from Andersen were closely involved in structuring the Raptors [SPE transactions]. . . . Enron's records show that Andersen billed Enron approximately $335,000 in connection with its work on the creation of the Raptors in the first several months of 2000.

Page 107: Causey [Enron's chief accounting officer] informed the Finance Committee that Andersen "had spent considerable time analyzing the Talon structure and the governance structure of LJM2 and was comfortable with the proposed [SPE] transaction."

Page 126: At the time [September 2001], Enron accounting personnel and Andersen concluded (using qualitative analysis) that the error [in a prior SPE transaction] was not material and a restatement was not necessary.

Page 129: Proper financial accounting does not permit this result [questionable accounting treatment for certain of Enron's SPE transactions]. To reach it, the accountants at Enron and Andersen—including the local engagement team and, apparently, Andersen's national office experts in Chicago—had to surmount numerous obstacles presented by pertinent accounting rules.

Page 132: It is particularly surprising that the accountants at Andersen, who should have brought a measure of objectivity and perspective to these transactions, did not do so. Based on the recollections of those involved in the transactions and a large collection of documentary evidence, there is no question that Andersen accountants were in a position to understand all the critical features of the Raptors and offer advice on the appropriate accounting treatment. Andersen's total bill for Raptor-related work came to approximately $1.3 million. Indeed, there is abundant evidence that Andersen in fact offered Enron advice

(*continued*)

EXHIBIT 3 — *continued*

SELECTED EXCERPTS FROM THE POWERS REPORT REGARDING ANDERSEN'S INVOLVEMENT IN KEY ACCOUNTING AND FINANCIAL REPORTING DECISIONS FOR ENRON'S SPE TRANSACTIONS

at every step, from inception through restructuring and ultimately to terminating the Raptors. Enron followed that advice.

Page 202: While we have not had the benefit of Andersen's position on a number of these issues, the evidence we have seen suggests Andersen accountants did not function as an effective check on the disclosure approach taken by the company. Andersen was copied on drafts of the financial statement footnotes and the proxy statements, and we were told that it routinely provided comments on the related-party transaction disclosures in response. We also understand that the Andersen auditors closest to Enron Global Finance were involved in drafting of at least some of the disclosures. An internal Andersen e-mail from February 2001 released in connection with recent Congressional hearings suggests that Andersen may have had concerns about the disclosures of the related-party transactions in the financial statement footnotes. Andersen did not express such concerns to the Board. On the contrary, Andersen's engagement partner told the Audit and Compliance Committee just a week after the internal e-mail that, with respect to related-party transactions, "'[r]equired disclosure [had been] reviewed for adequacy,' and that Andersen would issue an unqualified audit opinion on the financial statements."

Source: W. C. Powers, R. S. Troubh, and H. S. Winokur, "Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corporation," 1 February 2002.

Among the parties most critical of Andersen's extensive involvement in Enron's accounting and financial reporting decisions for SPE transactions was former SEC Chief Accountant Lynn Turner. During his tenure with the SEC in the 1990s, Turner had participated in the federal agency's investigation of Andersen's audits of Waste Management Inc. That investigation culminated in sanctions against several Andersen auditors and in a $1.4 billion restatement of Waste Management's financial statements, the largest accounting restatement in U.S. history at that time. Andersen eventually paid a reported $75 million in settlements to resolve various civil lawsuits linked to those audits and a $7 million fine to settle charges filed against the firm by the SEC.

In an interview with *The New York Times*, Turner suggested that the charges of shoddy audit work that had plagued Andersen in connection with its audits of Waste Management, Sunbeam, Enron, and other high-profile public clients was well-deserved.

Turner compared Andersen's problems with those experienced several years earlier by Coopers & Lybrand, a firm for which he had been an audit partner. According to Turner, a series of "blown audits" was the source of Coopers' problems. "We got bludgeoned to death in the press. People did not even want to see us at their doorsteps. It was brutal, but we deserved it. We had gotten into this mentality in the firm of making business judgment calls."[28] Clearly, the role of independent auditors does not include "making business judgments" for their clients. Instead, auditors have a responsibility to provide an objective point of view regarding the proper accounting and financial reporting decisions for those judgments.

Easily the source of the most embarrassment for Berardino and his Andersen colleagues was the widely publicized effort of the firm's Houston office to shred a large quantity of documents pertaining to various Enron audits. In early January 2002, Andersen officials informed federal investigators that personnel in the Houston office had "destroyed a significant but undetermined number of documents relating

28. F. Norris, "From Sunbeam to Enron, Andersen's Reputation Suffers," *The New York Times* (online), 23 November 2001.

to the company [Enron] and its finances."[29] That large-scale effort began in September 2001 and apparently continued into November after the SEC revealed it was conducting a formal investigation of Enron's financial affairs. The report of the shredding effort immediately caused many critics to suggest that Andersen's Houston office was attempting to prevent law enforcement authorities from obtaining potentially incriminating evidence regarding Andersen's role in Enron's demise. Senator Joseph Lieberman, chairman of the U.S. Senate Governmental Affairs Committee that would be investigating the Enron debacle, warned that the effort to dispose of the Enron-related documents might be particularly problematic for Andersen.

> *It [the document-shredding] came at a time when people inside, including the executives of Arthur Andersen and Enron, knew that Enron was in real trouble and that the roof was about to collapse on them, and there was about to be a corporate scandal. . . . [This] raises very serious questions about whether obstruction of justice occurred here. The folks at Arthur Andersen could be on the other end of an indictment before this is over. This Enron episode may end this company's history.*[30]

The barrage of criticism directed at Andersen continued unabated during the early months of 2002. Ironically, some of that criticism was directed at Andersen by Enron's top management. On January 17, 2002, Kenneth Lay issued a press release reporting that his company had decided to discharge Andersen as its independent audit firm.[31]

> *As announced on Oct. 31, the Enron Board of Directors convened a Special Committee to look into accounting and other issues relating to certain transactions. While we had been willing to give Andersen the benefit of the doubt until the completion of that investigation, we can't afford to wait any longer in light of recent events, including the reported destruction of documents by Andersen personnel and the disciplinary actions against several of Andersen's partners in its Houston office.*[32]

Throughout the public relations nightmare that besieged Andersen following Enron's bankruptcy filing, a primary tactic employed by Joseph Berardino was to insist repeatedly that poor business decisions, not errors on the part of Andersen, were responsible for Enron's downfall and the massive losses that ensued for investors, creditors, and other parties. "At the end of the day, we do not cause companies to fail."[33] Such statements failed to generate sympathy for Andersen. Even the editor-in-chief of ***Accounting Today***, one of the accounting profession's leading publications, was unmoved by Berardino's continual assertions that his firm was not responsible for the Enron fiasco. "If you accept the audit and collect the fee, then be prepared to accept the blame. Otherwise you're not part of the solution but rather part of the problem."[34]

29. K. Eichenwald and F. Norris, "Enron Auditor Admits It Destroyed Documents," *The New York Times* (online), 11 January 2002.

30. R. A. Oppel, "Andersen Says Lawyer Let Its Staff Destroy Files," *The New York Times* (online), 14 January 2002.

31. Kenneth Lay resigned as Enron's chairman of the board and CEO on January 23, 2002, one day after a court-appointed "creditors committee" had requested him to step down.

32. M. Palmer, "Enron Board Discharges Arthur Andersen in All Capacities," *Enron.com*, 17 January 2002.

33. M. Gordon, "Labor Secretary to Address Enron Hearings," *Associated Press* (online), 6 February 2002.

34. B. Carlino, "Enron Simply Newest Player in National Auditing Crisis," *The Electronic Accountant* (online), 17 December 2001.

Ridicule and Retrospection

As 2001 came to a close, *The New York Times* reported that the year had easily been the worst ever for Andersen, "the accounting firm that once deserved the title of the conscience of the industry."[35] The following year would prove to be an even darker time for the firm. During the early months of 2002, Andersen faced scathing criticism from Congressional investigators, enormous class-action lawsuits filed by angry Enron stockholders and creditors, and a federal criminal indictment stemming from the shredding of Enron-related documents.

In late March 2002, Joseph Berardino unexpectedly resigned as Andersen's CEO after failing to negotiate a merger of Andersen with one of the other Big Five firms. During the following few weeks, dozens of Andersen clients dropped the firm as their independent auditor out of concern that the firm might not survive if it was found guilty of the pending criminal indictment. The staggering loss of clients forced Andersen to lay off more than 25 percent of its workforce in mid-April. Shortly after that layoff was announced, U.S. Justice Department officials revealed that David Duncan, the former Enron audit engagement partner, had pleaded guilty to obstruction of justice and agreed to testify against his former firm. Duncan's plea proved to be the death knell for Andersen. In June 2002, a federal jury found the firm guilty of obstruction of justice. That conviction forced the firm to terminate its relationship with its remaining public clients, effectively ending Andersen's long and proud history within the U.S. accounting profession.

Three years later, the U.S. Supreme Court unanimously overturned the felony conviction handed down against Andersen. In an opinion written by Chief Justice William Rehnquist, the High court ruled that federal prosecutors did not prove that Andersen had *intended* to interfere with a federal investigation when the firm shredded the Enron audit workpapers. The Supreme Court's decision was little consolation to the more than 20,000 Andersen partners and employees who had lost their jobs when the accounting firm was forced out of business by the felony conviction.

Numerous Enron officials faced criminal indictments for their roles in the Enron fraud, among them Andrew Fastow, Jeffrey Skilling, and Kenneth Lay. Fastow pleaded guilty to conspiracy to commit securities fraud as well as to other charges. The former CFO received a 10-year prison term, which was reduced to six years after he testified against Skilling and Lay. Fastow was also required to forfeit nearly $25 million of personal assets that he had accumulated during his tenure at Enron. Largely as a result of Fastow's testimony against them, Skilling and Lay were convicted on multiple counts of fraud and conspiracy in May 2006. In September 2006, Skilling was sentenced to 24 years in prison. Kenneth Lay, who was to be sentenced at the same time, died of a massive heart attack in July 2006. Three months later, a federal judge overturned Lay's conviction since Lay was no longer able to pursue his appeal of that conviction.

The toll taken on the public accounting profession by the Enron debacle was not limited to Andersen, its partners, or its employees. An unending flood of jokes and ridicule directed at Andersen tainted and embarrassed practically every accountant in the nation, including both accountants in public practice and those working in the private sector. The Enron nightmare also prompted widespread soul-searching within the profession and a public outcry to strengthen the independent audit function and improve accounting and financial reporting practices. Legislative and regulatory authorities quickly responded to the public's demand for reforms.

The FASB imposed stricter accounting and financial reporting guidelines on SPEs as a direct result of the Enron case. Those new rules require most companies to include

35. Norris, "From Sunbeam to Enron."

the financial data for SPEs in their consolidated financial statements. In 2002, Congress passed the Sarbanes-Oxley Act to strengthen financial reporting for public companies, principally by improving the rigor and quality of independent audits. Among other requirements, the Sarbanes-Oxley Act limits the types of consulting services that independent auditors can provide to their clients and requires public companies to prepare annual reports on the quality of their internal controls. The most sweeping change in the profession resulting from the Enron fiasco was the creation of a new federal agency, the Public Company Accounting Oversight Board, to oversee the rule-making process for the independent audit function.

Among the prominent individuals who commented on the challenges and problems facing the accounting profession was former SEC Chairman Richard Breeden when he testified before Congress in early 2002. Chairman Breeden observed that there was a simple solution to the quagmire facing the profession. He called on accountants and auditors to adopt a simple rule of thumb when analyzing, recording, and reporting on business transactions, regardless of whether those transactions involved "New Economy" or "Old Economy" business ventures. "When you're all done, the result had better fairly reflect what you see in reality."[36]

In retrospect, Commissioner Breeden's recommendation seems to be a restatement of the "Think straight, talk straight" motto of Arthur E. Andersen. Andersen and his colleagues insisted that their audit clients adhere to a high standard of integrity when preparing their financial statements. An interview with Joseph Berardino by *The New York Times* in December 2001 suggests that Mr. Berardino and his contemporaries may have had a different attitude when it came to dealing with cantankerous clients such as Enron: "In an interview yesterday, Mr. Berardino said Andersen had no power to force a company to disclose that it had hidden risks and losses in special-purpose entities. 'A client says: 'There is no requirement to disclose this. You can't hold me to a higher standard.'"[37]

Berardino is certainly correct in his assertion. An audit firm cannot force a client to adhere to a higher standard. In fact, even Arthur Edward Andersen did not have that power. But Mr. Andersen did have the resolve to tell such clients to immediately begin searching for another audit firm.

Questions

1. The Enron debacle created what one public official reported was a "crisis of confidence" on the part of the public in the accounting profession. List the parties who you believe were most responsible for that crisis. Briefly justify each of your choices.
2. List three types of consulting services that audit firms are now prohibited from providing to clients that are public companies. For each item, indicate the specific threats, if any, that the provision of the given service could pose for an audit firm's independence.
3. For purposes of this question, assume that the excerpts from the Powers Report shown in Exhibit 3 provide accurate descriptions of Andersen's involvement in Enron's accounting and financial reporting decisions. Given this assumption, do you believe that Andersen's involvement in those decisions violated any professional auditing standards? If so, list those standards and briefly explain your rationale.

36. R. Schlank, "Former SEC Chairmen Urge Congress to Free FASB," *AccountingWeb* (online), 15 February 2002.

37. F. Norris, "The Distorted Numbers at Enron," *The New York Times* (online), 14 December 2001.