CONTEMPORARY AUDITING

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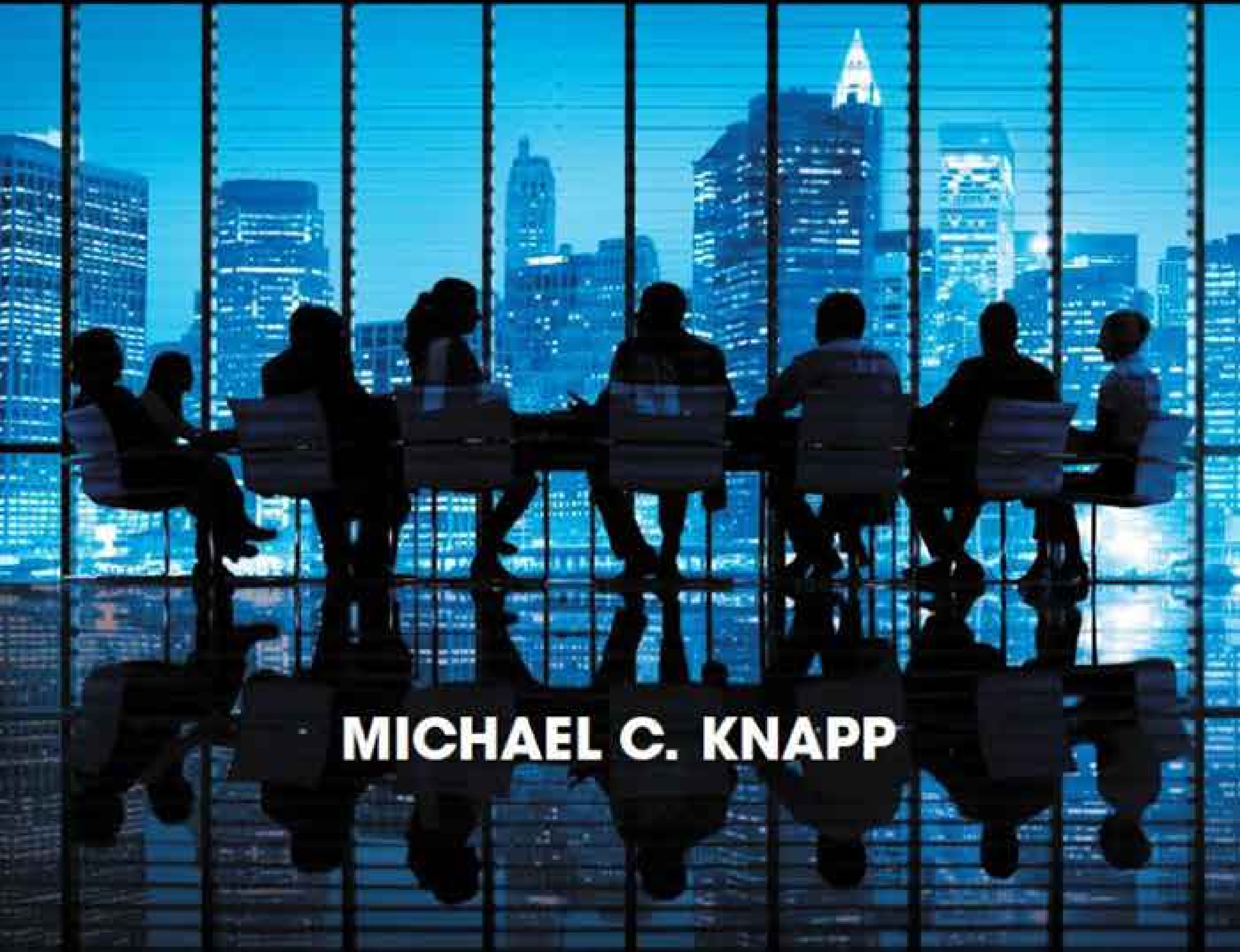

MICHAEL C. KNAPP

Contemporary Auditing

Real Issues and Cases

Tenth Edition

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Michael C. Knapp
University of Oklahoma

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DEDICATION

To Carol, Johnny, Lindsay, Jessi, and Emmie

BRIEF CONTENTS

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PREFACE

The past dozen years has been one of the most turbulent time periods in the history of the accounting profession and the independent audit function. Shortly after the turn of the century, the Enron and WorldCom fiascoes focused the attention of the investing public, the press, Wall Street, and, eventually, Congress on our profession. The Enron and WorldCom scandals resulted in the passage of the Sarbanes–Oxley Act of 2002 (SOX) and the creation of the Public Company Accounting Oversight Board (PCAOB). The SOX statute imposed a litany of new responsibilities and constraints on auditors of public companies, including the need to audit their clients' internal controls and prohibiting them from providing certain consulting services to their clients.

Next came the campaign to replace U.S. generally accepted accounting principles (GAAP) with International Financial Reporting Standards (IFRS). That campaign stalled when the subprime mortgage crisis in the United States caused global stock markets to implode and global credit markets to "freeze" during the fall of 2008. This economic downturn claimed many companies that had been stalwarts of the U.S. economy, the prime example being Lehman Brothers. Most of these companies, including Lehman Brothers, had received "clean" audit opinions on their financial statements one year or less before they collapsed.

As Congress and regulatory authorities struggled to revive the U.S. economy, news of the largest Ponzi scheme in world history grabbed the headlines in early 2009. Investors worldwide were shocked to learn that Bernie Madoff, an alleged "wizard of Wall Street," was a fraud. Law enforcement authorities determined that billions of dollars of client investments supposedly being held by Madoff's company, Madoff Securities, did not exist. The business press was quick to report that for decades Madoff Securities' financial statements had received unqualified audit opinions each year from a New York accounting firm. The auditing discipline absorbed another body blow in 2010 when a court-appointed bankruptcy examiner publicly singled out Lehman Brothers' former audit firm as one of the parties allegedly most responsible for the massive financial losses produced by the collapse of that Wall Street investment bank.

More recently, the aggressive regulatory stance taken by the PCAOB has resulted in public reprimands for several of the large accounting firms that dominate the auditing discipline. Additionally, the PCAOB's proposal to consider mandatory rotation for public company audit firms stirred a far-reaching controversy in the profession that ultimately prompted the U.S. Congress to weigh in on that issue.

As academics, we have a responsibility to help shepherd our profession through these turbulent times. Auditing instructors, in particular, have an obligation to help restore the credibility of the independent audit function that has been adversely impacted by recent events. To accomplish this latter goal, one strategy we can use is to embrace the reforms recommended years ago by the Accounting Education

Change Commission (AECC), many of which have been embraced by the more recent Pathways Commission, a joint project of the American Institute of Certified Public Accountants and the American Accounting Association. Among the AECC's recommendations was that accounting educators employ a broader array of instructional resources, particularly experiential resources, designed to stimulate active learning by students. In fact, the intent of my casebook is to provide auditing instructors with a source of such materials that can be used in both undergraduate and graduate auditing courses.

This casebook stresses the "people" aspect of independent audits. If you review a sample of recent "audit failures," you will find that problem audits seldom result from inadequate audit technology. Instead, deficient audits typically result from the presence of one, or both, of the following two conditions: client personnel who intentionally subvert an audit or auditors who fail to carry out the responsibilities assigned to them. Exposing students to problem audits will help them recognize the red flags that often accompany audit failures. An ability to recognize these red flags and the insight gained by discussing and dissecting problem audits will allow students to cope more effectively with the problematic situations they are certain to encounter in their own careers. In addition, this experiential approach provides students with context-specific situations that make it much easier for them to grasp the relevance of important auditing topics, concepts, and procedures.

The cases in this text also acquaint students with the work environment of auditors. After studying these cases, students will better appreciate how client pressure, peer pressure, time budgets, and related factors complicate the work roles of independent auditors. Also embedded in these cases are the ambiguity and lack of structure that auditors face each day. Aspects of the audit environment representing those two conditions that are woven into my cases include missing documents, conflicting audit evidence, auditors' dual obligation to the client and to financial statement users, and the lack of definitive professional standards for many situations.

The tenth edition of my casebook contains the following eight sections of cases: Comprehensive Cases, Audits of High-Risk Accounts, Internal Control Issues, Ethical Responsibilities of Accountants, Ethical Responsibilities of Independent Auditors, Professional Roles, Professional Issues, and International Cases. This organizational structure is intended to help adopters readily identify cases best suited for their particular needs.

My casebook can be used in several different ways. Adopters can use the casebook as a supplemental text for the undergraduate auditing course or as a primary text for a graduate-level seminar in auditing. The instructor's manual contains a syllabus for a graduate auditing course organized around this text. This casebook can also be used in the capstone professional practice course incorporated in many five-year accounting programs. Customized versions of this casebook are suitable for a wide range of accounting courses as explained later.

In preparing this edition, I retained those cases that have been among the most widely used by adopters. These cases include, among others, Enron Corporation, Golden Bear Golf, *Hopkins v. Price Waterhouse*, Lehman Brothers, Leigh Ann Walker, Madoff Securities, The Trolley Dodgers, and ZZZZ Best Company. You will find that many of the "returning" cases have been updated for relevant circumstances and events that have occurred since the publication of the previous edition.

New To This Edition This edition features 18 new cases. Three of these new cases are Comprehensive cases, including AA Capital Partners, DHB Industries, and Navistar International Corporation. The AA Capital Partners case focuses on the 2004 audits of a Chicago-based investment firm and its four private equity funds. AA Capital's auditors discovered $1.92 million of suspicious cash payments made to one of the firm's two cofounders, which was a small slice of the $24 million of funds embezzled by that individual from the firm. The SEC concluded that the auditors failed to properly investigate the suspicious cash payments they discovered, which, in turn, prevented them from uncovering the embezzlement scheme. Surprisingly, a federal judge subsequently ruled that the AA Capital audit engagement partner was not culpable because the audit manager on the engagement had failed to properly inform him of the suspicious payments discovered during the 2004 audits. After striking the sanctions that the SEC had recommended for the audit partner, the judge suspended the audit manager from practicing before the SEC for one year.

In July 2006, the founder and CEO of DHB Industries was dismissed by the company's board. Over the following year, a forensic investigation revealed that the company's impressive operating results from 2003 through 2005 had been the product of an accounting fraud. The CEO and two of his top subordinates had routinely altered DHB's accounting records to achieve earnings targets that he had established for the company. A major problem faced by the conspirators was concealing their misdeeds from the company's independent auditors. Accomplishing that objective was made easier by the fact that between 2001 and 2005 the company had four different accounting firms serve as its independent auditors. Frequent clashes between management and the company's auditors were responsible for the almost annual changes in auditors during that period.

As Navistar's 2005 audit was nearing completion, Deloitte, its audit firm, suddenly replaced the audit engagement partner. The new engagement partner effectively started the audit over, refusing to rely upon the work supervised by his predecessor. In April 2006, well after Navistar had missed its filing deadline for its annual Form 10-K with the SEC, Navistar dismissed Deloitte, which had served as its audit firm for 98 years. More than 18 months passed before the replacement audit firm, KPMG, completed the 2005 Navistar audit, which finally allowed Navistar to file its 2005 Form 10-K with the SEC. KPMG's audit was extended by a series of large accounting misstatements and internal control weaknesses discovered by the audit team. The PCAOB eventually launched an investigation of Deloitte's audits of Navistar, which was the first formal investigation of a Big Four accounting firm by that agency.

The Navistar case was apparently a key factor that prompted the PCAOB to suggest that mandatory audit firm rotation might be necessary to enhance auditor independence and the quality of independent audits.

Five of the new cases in this edition are included in two sections of my casebook that historically have been among the most popular: Audits of High-Risk Accounts and Internal Control Issues. New cases in the Audits of High-Risk Accounts section include LocatePlus Holdings Corporation, Powder River Petroleum International, and Take-Two Interactive Software. The executives of LocatePlus, a company with a New Age business model based upon a huge database containing information profiles for 98 percent of all U.S. citizens, used an Old School fraud scheme—imaginary revenues from fictitious customers—to deceive their auditors. The Powder River case highlights a Ponzi scheme involving the sale of "working interests" in oil and gas properties. Both the SEC and PCAOB chastened Powder River's independent auditors for their busted audits of the company. Take-Two produces *Grand Theft Auto*, the sixth best-selling video game "franchise" of all time and easily one of the most controversial thanks to its adult content. The Take-Two case revolves around inadequate audit tests applied to accounts receivable by the company's auditors and the father–son relationship that developed between Take-Two's audit engagement partner and the company's young founder.

The Boeing Company and Walmart de Mexico are the new cases in the Internal Control Issues section. The Boeing case examines the internal control and whistleblowing provisions of the Sarbanes–Oxley Act. Among other topics, the case questions require students to review the five components of the COSO internal control framework and to explain the difference between a "significant deficiency" and a "material weakness" in internal control. The Walmart de Mexico case raises internal control, auditing, and ethical issues stemming from Walmart's alleged violations of the Foreign Corrupt Practices Act (FCPA). Specific issues addressed by the case questions include internal control activities that may be effective in minimizing the risk of FCPA violations by public companies, the responsibility of auditors to detect and report illegal acts by clients, and the impact of differing cultural values on the ability of multinational companies to maintain proper internal control over their operations.

The two sections of my casebook that focus on ethical issues each have three new cases in this edition. The cases new to Section 4, Ethical Responsibilities of Accountants, include Accuhealth, Dell, and Wichita Falls. In Section 5, Ethical Responsibilities of Independent Auditors, I believe you will enjoy the new cases IPOC International Growth Fund; Richard Grimes, Staff Accountant; and Ryden Trucking. Accuhealth, a refurbished case that appeared in an earlier edition of my casebook, highlights an ethical dilemma faced by an accountant who stumbles upon evidence of an embezzlement ring masterminded by his new employer's top executives. The Dell case documents a pervasive earnings management scheme overseen by Michael Dell and his colleagues that involved huge "exclusivity payments" made to Dell, Inc. by its major supplier, Intel Corporation. My new Wichita Falls case examines ethical issues that the surviving partners of a Texas CPA firm faced after the death of the firm's managing partner.

The IPOC International Growth Fund case could serve as the basis for a Hollywood screenplay. That case centers on a KPMG employee who became an unwitting pawn in an international chess match of corporate espionage and murder that involved a close associate of Vladimir Putin, the Russian president at the time. Richard Grimes is an entry-level auditor who overhears a conversation between two client executives. That conversation involves a plan to withhold critical audit-relevant information from Grimes and the other members of the given company's audit team. Ryden Trucking is another refurbished case that appeared in a much earlier edition of my casebook. This case examines the thorny problems faced by an accounting firm when one of its audit staff employees embezzles cash from an audit client.

New cases in Section 7, Professional Issues, include Elizabeth Wallace, Audit Senior; Frank Coleman, Staff Accountant; and Olivia Thomas, Audit Senior. The Elizabeth Wallace case focuses on a social problem that has reached an epidemic level in our country and affects even professionals employed by major accounting firms, namely, prescription drug abuse. The Frank Coleman case addresses the huge class-action lawsuits that major accounting firms face for allegedly failing to compensate certain employees for the overtime hours that they have worked. An issue that is a taboo topic within most professional services firms—intra-office dating—is the orienting focus of the Olivia Thomas case.

The final case new to this edition is an international case, Longtop Financial Technologies Limited. In the spring of 2011, just as D & T Shanghai was completing its annual audit of Longtop, a Shanghai-based software company, allegations surfaced that company officials were fraudulently misrepresenting the company's financial data. A few days later, D & T Shanghai resigned as Longtop's auditor after determining that the allegations of fraud were true. The Longtop fraud focused attention on an issue that had been simmering in the United States for several years, namely, the refusal of the Chinese government to allow the PCAOB to inspect accounting firms, such as D & T Shanghai, that audit non-U.S. companies that have securities traded on U.S. stock exchanges. The international brouhaha stemming from the Longtop case escalated when D & T Shanghai refused to cooperate with the SEC's investigation of the Longtop fraud. D & T Shanghai officials insisted that an important Chinese federal statute precluded them from becoming involved in the SEC's investigation.

Organization of Casebook Listed next are brief descriptions of the eight groups of cases included in this text. The casebook's Table of Contents presents an annotated description of each case.

Comprehensive Cases Most of these cases deal with highly publicized problem audits performed by the major international accounting firms. Among the clients involved in these audits are Enron Corporation, Lehman Brothers, The Leslie Fay Companies, Livent, Madoff Securities, and ZZZZ Best Company. Each of these cases addresses a wide range of auditing, accounting, and ethical issues.

Audits of High-Risk Accounts In contrast to the cases in the prior section, these cases highlight contentious accounting and auditing issues posed by a single account or group of accounts. For example, the Jack Greenberg case focuses primarily on inventory audit procedures. The Take-Two Interactive Software case raises audit issues relevant to accounts receivable, while the Belot Enterprises case examines auditing issues pertinent to period-ending expense accruals.

Internal Control Issues The cases in this section introduce students to internal control topics relevant to the performance of independent audits. These topics are examined in a variety of different client contexts. For example, the Goodner Brothers case focuses on internal control issues for a wholesaler, while the Howard Street Jewelers case provides students an opportunity to discuss control issues relevant to retail businesses.

Ethical Responsibilities of Accountants Integrating ethics into an auditing course requires much more than simply discussing the AICPA's *Code of Professional Conduct*. This section presents specific scenarios in which accountants have been forced to deal with perplexing ethical dilemmas. By requiring students to study actual situations in which important ethical issues have arisen, they will be better prepared to resolve similar situations in their own professional careers. Three of the cases in this section will "strike close to home" for your students since they involve accounting majors. For example, in the Wiley Jackson case, a soon-to-graduate accounting major must decide whether to disclose in a preemployment document a minor-in-possession charge that is pending against him. Another case in this section, Freescale Semiconductor, addresses an embarrassing series of insider trading cases involving professional accountants.

Ethical Responsibilities of Independent Auditors The cases in this section highlight ethical dilemmas encountered by independent auditors. In the Cardillo Travel Systems case, two audit partners face an ethical dilemma that most audit practitioners will experience at some point during their careers. The two partners are forced to decide whether to accept implausible explanations for a suspicious client transaction given to them by client executives or, alternatively, whether to "complicate" the given engagement by insisting on fully investigating the transaction.

Professional Roles Cases in this section examine specific work roles in the auditing discipline. These cases explore the responsibilities associated with those roles and related challenges that professionals occupying them commonly encounter. The Tommy O'Connell case involves a young auditor recently promoted to audit senior. Shortly following his promotion, Tommy finds himself assigned to supervise a small but challenging audit. Tommy's sole subordinate on that engagement happens to be a young man whose integrity and work ethic have been questioned by seniors he has worked for previously. Two cases in this section spotlight the staff accountant work role, which many of your students will experience firsthand following graduation.

Professional Issues Similar to other professions, pervasive social issues such as sexual harassment, racial discrimination, and drug abuse influence the work roles and work environment of independent auditors. Cases in this section examine those sensitive but important topics in the context of independent auditing. The Elizabeth Wallace case, for example, documents how prescription drug abuse can adversely affect the personal and professional lives of independent auditors, while the Sarah Russell and *Hopkins v. Price Waterhouse* cases explore unique problems that women face in pursuing careers in public accounting. The amount of overtime worked by independent auditors, the immense legal liability of major accounting firms, and the overarching quality control issues facing those firms are among other topics addressed by cases in this section.

International Cases The purpose of these cases is to provide your students with an introduction to important issues facing the global accounting profession and auditing discipline. Several of these cases document unique challenges that must be dealt with by auditors and accountants in certain countries or regions of the world. For example, the Kaset Thai Sugar Company case vividly demonstrates that auditors and accountants may be forced to cope with hostile and sometimes dangerous working conditions in developing countries where their professional roles and responsibilities are not well understood or appreciated. Likewise, the Longtop Financial Technologies case documents how cultural differences across the globe may impact the performance of independent audits.

Customize Your Own Casebook To maximize your flexibility in using these cases, South-Western/Cengage Learning has included *Contemporary Auditing: Real Issues and Cases* in its customized publishing program, Make It Yours. Adopters have the option of creating a customized version of this casebook ideally suited for their specific needs. At the University of Oklahoma, a customized selection of my cases is used to add an ethics component to the undergraduate managerial accounting course. In fact, since the cases in this text examine ethical issues across a wide swath of different contexts, adopters can develop a customized ethics casebook to supplement almost any accounting course.

This casebook is ideally suited to be customized for the undergraduate auditing course. For example, auditing instructors who want to add a strong international component to their courses can develop a customized edition of this text that includes a series of international cases. Likewise, to enhance the coverage of ethical issues in the undergraduate auditing course, instructors could choose a series of cases from this text that highlight important ethical issues. Following are several examples of customized versions of this casebook that could be easily integrated into the undergraduate auditing course.

> *International Focus*: Longtop Financial Technologies (8.1), Kaset Thai Sugar Company (8.2), Republic of Somalia (8.3), *Shari'a* (8.5), and *Tae Kwang Vina* (8.7). This custom casebook would provide your students with insight on some of the most important issues that major accounting firms face when they enter foreign markets.

Ethics Focus (I): Suzette Washington, Accounting Major (4.3), Wiley Jackson, Accounting Major (4.5), Arvel Smart, Accounting Major (4.6), Leigh Ann Walker, Staff Accountant (6.1), Hamilton Wong, In-Charge Accountant (6.3), Avis Love, Staff Accountant (6.5). The first three cases give students an opportunity to discuss and debate ethical issues directly pertinent to them as accounting majors. The final three cases expose students to important ethical issues they may encounter shortly after graduation if they choose to enter public accounting.

Ethics Focus (II): Creve Couer Pizza (4.1), F&C International (4.2), Freescale Semiconductor (4.4), David Quinn, Tax Accountant (4.7), American International Group (5.2), Ryden Trucking (5.6). This selection of cases is suitable for auditing instructors who have a particular interest in covering a variety of ethical topics relevant to the AICPA's *Code of Professional Conduct*, several of which are not directly or exclusively related to auditing.

Applied Focus: Enron Corporation (1.1), NextCard (1.6), ZZZZ Best Company (1.9), Livent (1.15), Belot Enterprises (2.8), Cardillo Travel Systems (5.1). This series of cases will provide students with a broad-brush introduction to the *real world* of independent auditing. These cases raise a wide range of technical, professional, and ethical issues in a variety of client contexts.

Professional Roles Focus: Leigh Ann Walker, Staff Accountant (6.1), Bill DeBurger, In-Charge Accountant (6.2), Tommy O'Connell, Audit Senior (6.4), Avis Love, Staff Accountant (6.5), Charles Tollison, Audit Manager (6.6), Ligand Pharmaceuticals (7.1). This custom casebook would be useful for auditing instructors who choose to rely on a standard textbook to cover key technical topics in auditing—but who also want to expose their students to the everyday ethical and professional challenges faced by individuals occupying various levels of the employment hierarchy within auditing firms.

High-Risk Accounts Focus: Each of the cases in Section 2, Audits of High-Risk Accounts. This series of cases will provide your students with relatively intense homework assignments that focus almost exclusively on the financial statement line items that pose the greatest challenges for auditors.

Of course, realize that you are free to choose any "mix" of my cases to include in a customized casebook for an undergraduate auditing course or another accounting course that you teach. For more information on how to design your customized casebook, please contact your South-Western/Cengage Learning sales representative or visit the textbook website: www.cengage.com/custom/makeityours/knapp.

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SECTION 1

COMPREHENSIVE CASES

CASE 1.1

Enron Corporation

John and Mary Andersen immigrated to the United States from their native Norway in 1881. The young couple made their way to the small farming community of Plano, Illinois, some 40 miles southwest of downtown Chicago. Over the previous few decades, hundreds of Norwegian families had settled in Plano and surrounding communities. In fact, the aptly named Norway, Illinois, was located just a few miles away from the couple's new hometown. In 1885, Arthur Edward Andersen was born. From an early age, the Andersens' son had a fascination with numbers. Little did his parents realize that Arthur's interest in numbers would become the driving force in his life. Less than one century after he was born, an accounting firm bearing Arthur Andersen's name would become the world's largest professional services organization with more than 1,000 partners and operations in dozens of countries scattered across the globe.

Think Straight, Talk Straight

Discipline, honesty, and a strong work ethic were three key traits that John and Mary Andersen instilled in their son. The Andersens also constantly impressed upon him the importance of obtaining an education. Unfortunately, Arthur's parents did not survive to help him achieve that goal. Orphaned by the time he was a young teenager, Andersen was forced to take a full-time job as a mail clerk and attend night classes to work his way through high school. After graduating from high school, Andersen attended the University of Illinois while working as an accountant for Allis-Chalmers, a Chicago-based company that manufactured tractors and other farming equipment. In 1908, Andersen accepted a position with the Chicago office of Price Waterhouse. At the time, Price Waterhouse, which was organized in Great Britain during the early nineteenth century, easily qualified as the United States' most prominent public accounting firm.

At age 23, Andersen became the youngest CPA in the state of Illinois. A few years later, Andersen and a friend, Clarence Delany, established a partnership to provide accounting, auditing, and related services. The two young accountants named their firm Andersen, Delany & Company. When Delany decided to go his own way, Andersen renamed the firm Arthur Andersen & Company.

In 1915, Arthur Andersen faced a dilemma that would help shape the remainder of his professional life. One of his audit clients was a freight company that owned and operated several steam freighters that delivered various commodities to ports located on Lake Michigan. Following the close of the company's fiscal year but before Andersen had issued his audit report on its financial statements, one of the client's ships sank in Lake Michigan. At the time, there were few formal rules for companies to follow in preparing their annual financial statements and certainly no rule that required the company to report a material "subsequent event" occurring after the close of its fiscal year—such as the loss of a major asset. Nevertheless, Andersen insisted that his client disclose the loss of the ship. Andersen reasoned that third parties who would use the company's financial statements, among them the company's banker, would want to be informed of the loss. Although unhappy with Andersen's position, the client eventually acquiesced and reported the loss in the footnotes to its financial statements.

Two decades after the steamship dilemma, Arthur Andersen faced a similar situation with an audit client that was much larger, much more prominent, and much more profitable for his firm. Arthur Andersen & Co. served as the independent auditor for the giant chemical company DuPont. As the company's audit neared completion one year, members of the audit engagement team and executives of DuPont quarreled over how to define the company's operating income. DuPont's management insisted on a liberal definition of operating income that included income earned on certain investments. Arthur Andersen was brought in to arbitrate the dispute. When he sided with his subordinates, DuPont's management team dismissed the firm and hired another auditor.

Throughout his professional career, Arthur E. Andersen relied on a simple, four-word motto to serve as a guiding principle in making important personal and professional decisions: "Think straight, talk straight." Andersen insisted that his partners and other personnel in his firm invoke that simple rule when dealing with clients, potential clients, bankers, regulatory authorities, and any other parties they interacted with while representing Arthur Andersen & Co. He also insisted that audit clients "talk straight" in their financial statements. Former colleagues and associates often described Andersen as opinionated, stubborn, and, in some cases, "difficult." But even his critics readily admitted that Andersen was point-blank honest. "Arthur Andersen wouldn't put up with anything that wasn't complete, 100% integrity. If anybody did anything otherwise, he'd fire them. And if clients wanted to do something he didn't agree with, he'd either try to change them or quit."[1]

As a young professional attempting to grow his firm, Arthur Andersen quickly recognized the importance of carving out a niche in the rapidly developing accounting services industry. Andersen realized that the nation's bustling economy of the 1920s depended heavily on companies involved in the production and distribution of energy. As the economy grew, Andersen knew there would be a steadily increasing need for electricity, oil and gas, and other energy resources. So he focused his practice development efforts on obtaining clients involved in the various energy industries. Andersen was particularly successful in recruiting electric utilities as clients. By the early 1930s, Arthur Andersen & Co. had a thriving practice in the upper Midwest and was among the leading regional accounting firms in the nation.

The U.S. economy's precipitous downturn during the Great Depression of the 1930s posed huge financial problems for many of Arthur Andersen & Co.'s audit clients in the electric utilities industry. As the Depression wore on, Arthur Andersen personally worked with several of the nation's largest metropolitan banks to help his clients obtain the financing they desperately needed to continue operating. The bankers and other leading financiers who dealt with Arthur Andersen quickly learned of his commitment to honesty and proper, forthright accounting and financial reporting practices. Andersen's reputation for honesty and integrity allowed lenders to use with confidence financial data stamped with his approval. The end result was that many troubled firms received the financing they needed to survive the harrowing days of the 1930s. In turn, the respect that Arthur Andersen earned among leading financial executives nationwide resulted in Arthur Andersen & Co. receiving a growing number of referrals for potential clients located outside of the Midwest.

During the later years of his career, Arthur Andersen became a spokesperson for his discipline. He authored numerous books and presented speeches throughout the nation regarding the need for rigorous accounting, auditing, and ethical standards for the emerging public accounting profession. Andersen continually urged

1. R. Frammolino and J. Leeds, "Andersen's Reputation in Shreds," *Los Angeles Times* (online), 30 January 2002.

his fellow accountants to adopt the public service ideal that had long served as the underlying premise of the more mature professions such as law and medicine. He also lobbied for the adoption of a mandatory continuing professional education (CPE) requirement. Andersen realized that CPAs needed CPE to stay abreast of developments in the business world that had significant implications for accounting and financial reporting practices. In fact, Arthur Andersen & Co. made CPE mandatory for its employees long before state boards of accountancy adopted such a requirement.

By the mid-1940s, Arthur Andersen & Co. had offices scattered across the eastern one-half of the United States and employed more than 1,000 accountants. When Arthur Andersen died in 1947, many business leaders expected that the firm would disband without its founder, who had single-handedly managed its operations over the previous four decades. But, after several months of internal turmoil and dissension, the firm's remaining partners chose Andersen's most trusted associate and protégé to replace him.

Like his predecessor and close friend who had personally hired him in 1928, Leonard Spacek soon earned a reputation as a no-nonsense professional—an auditor's auditor. He passionately believed that the primary role of independent auditors was to ensure that their clients reported fully and honestly regarding their financial affairs to the investing and lending public.

Spacek continued Arthur Andersen's campaign to improve accounting and auditing practices in the United States during his long tenure as his firm's chief executive. "Spacek openly criticized the profession for tolerating what he considered a sloppy patchwork of accounting standards that left the investing public no way to compare the financial performance of different companies."[2] Such criticism compelled the accounting profession to develop a more formal and rigorous rule-making process. In the late 1950s, the profession created the Accounting Principles Board (APB) to study contentious accounting issues and develop appropriate new standards. The APB was replaced in 1973 by the Financial Accounting Standards Board (FASB).

Another legacy of Arthur Andersen that Leonard Spacek sustained was requiring the firm's professional employees to continue their education throughout their careers. During Spacek's tenure, Arthur Andersen & Co. established the world's largest private university, the Arthur Andersen & Co. Center for Professional Education located in St. Charles, Illinois, not far from Arthur Andersen's birthplace.

Leonard Spacek's strong leadership and business skills transformed Arthur Andersen & Co. into a major international accounting firm. When Spacek retired in 1973, Arthur Andersen & Co. was arguably the most respected accounting firm not only in the United States, but worldwide as well. Three decades later, shortly after the dawn of the new millennium, Arthur Andersen & Co. employed more than 80,000 professionals, had practice offices in more than 80 countries, and had annual revenues approaching $10 billion. However, in late 2001, the firm, which by that time had adopted the one-word name "Andersen," faced the most significant crisis in its history since the death of its founder. Ironically, that crisis stemmed from Andersen's audits of an energy company, a company founded in 1930 that, like many of Arthur Andersen's clients, had struggled to survive the Depression.

The World's Greatest Company

Northern Natural Gas Company was founded in Omaha, Nebraska, in 1930. The principal investors in the new venture included a Texas-based company, Lone Star Gas Corporation. During its first few years of existence, Northern wrestled with the problem

2. *Ibid.*

of persuading consumers to use natural gas to heat their homes. Concern produced by several unfortunate and widely publicized home "explosions" caused by natural gas leaks drove away many of Northern's potential customers. But, as the Depression wore on, the relatively cheap cost of natural gas convinced increasing numbers of cold-stricken and shallow-pocketed consumers to become Northern customers.

The availability of a virtually unlimited source of cheap manual labor during the 1930s allowed Northern to develop an extensive pipeline network to deliver natural gas to the residential and industrial markets that it served in the Great Plains states. As the company's revenues and profits grew, Northern's management launched a campaign to acquire dozens of its smaller competitors. This campaign was prompted by management's goal of making Northern the largest natural gas supplier in the United States. In 1947, the company, which was still relatively unknown outside of its geographical market, reached a major milestone when its stock was listed on the New York Stock Exchange. That listing provided the company with greater access to the nation's capital markets and the financing needed to continue its growth-through-acquisition strategy over the following two decades.

During the 1970s, Northern became a principal investor in the development of the Alaskan pipeline. When completed, that pipeline allowed Northern to tap vast natural gas reserves it had acquired in Canada. In 1980, Northern changed its name to InterNorth, Inc. Over the next few years, company management extended the scope of the company's operations by investing in ventures outside of the natural gas industry, including oil exploration, chemicals, coal mining, and fuel-trading operations. But the company's principal focus remained the natural gas industry. In 1985, InterNorth purchased Houston Natural Gas Company for $2.3 billion. That acquisition resulted in InterNorth controlling a 40,000-mile network of natural gas pipelines and allowed it to achieve its long-sought goal of becoming the largest natural gas company in the United States.

In 1986, InterNorth changed its name to Enron. Kenneth Lay, the former chairman of Houston Natural Gas, emerged as the top executive of the newly created firm that chose Houston, Texas, as its corporate headquarters. Lay quickly adopted the aggressive growth strategy that had long dominated the management policies of InterNorth and its predecessor. Lay hired Jeffrey Skilling to serve as one of his top subordinates. During the 1990s, Skilling developed and implemented a plan to transform Enron from a conventional natural gas supplier into an energy-trading company that served as an intermediary between producers of energy products, principally natural gas and electricity, and end users of those commodities. In early 2001, Skilling assumed Lay's position as Enron's chief executive officer (CEO), although Lay retained the title of chairman of the board. In the management letter to shareholders included in Enron's 2000 annual report, Lay and Skilling explained the metamorphosis that Enron had undergone over the previous 15 years:

> *Enron hardly resembles the company we were in the early days. During our 15-year history, we have stretched ourselves beyond our own expectations. We have 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.*

Enron's 2000 annual report discussed the company's four principal lines of business. Energy Wholesale Services ranked as the company's largest revenue producer. That division's 60 percent increase in transaction volume during 2000 was fueled by the rapid development of EnronOnline, a B2B (business-to-business) electronic marketplace for the energy industries created in late 1999 by Enron. During fiscal 2000 alone,

EXHIBIT 1

ENRON CORPORATION 2000 ANNUAL REPORT FINANCIAL HIGHLIGHTS TABLE (IN MILLIONS EXCEPT FOR PER SHARE AMOUNTS)

	2000	1999	1998	1997	1996
Revenues	$100,789	$40,112	$31,260	$20,273	$13,289
Net Income:					
Operating Results	1,266	957	698	515	493
Items Impacting Comparability	(287)	(64)	5	(410)	91
Total	979	893	703	105	584
Earnings Per Share:					
Operating Results	1.47	1.18	1.00	.87	.91
Items Impacting Comparability	(.35)	(.08)	.01	(.71)	.17
Total	1.12	1.10	1.01	.16	1.08
Dividends Per Share:	.50	.50	.48	.46	.43
Total Assets:	65,503	33,381	29,350	22,552	16,137
Cash from Operating Activities:	3,010	2,228	1,873	276	742
Capital Expenditures and Equity Investments:	3,314	3,085	3,564	2,092	1,483
NYSE Price Range:					
High	90.56	44.88	29.38	22.56	23.75
Low	41.38	28.75	19.06	17.50	17.31
Close, December 31	83.12	44.38	28.53	20.78	21.56

EnronOnline processed more than $335 billion of transactions, easily making Enron the largest e-commerce company in the world. Enron's three other principal lines of business included Enron Energy Services, the company's retail operating unit; Enron Transportation Services, which was responsible for the company's pipeline operations; and Enron Broadband Services, a new operating unit intended to be an intermediary between users and suppliers of broadband (Internet access) services. Exhibit 1 presents the five-year financial highlights table included in Enron's 2000 annual report.

The New Economy business model that Enron pioneered for the previously staid energy industries caused Kenneth Lay, Jeffrey Skilling, and their top subordinates to be recognized as skillful entrepreneurs and to gain superstar status in the business world. Lay's position as the chief executive of the nation's seventh-largest firm gave him direct access to key political and governmental officials. In 2001, Lay served on the "transition team" responsible for helping usher in the administration of President-elect George W. Bush. In June 2001, Skilling was singled out as "the No. 1 CEO in the entire country," while Enron was hailed as "America's most innovative company."[3] Enron's chief financial officer (CFO) Andrew Fastow was recognized for creating the

3. K. Eichenwald and D. B. Henriques, "Web of Details Did Enron In as Warnings Went Unheeded," *New York Times* (online), 10 February 2002.

financial infrastructure for one of the nation's largest and most complex companies. In 1999, *CFO Magazine* presented Fastow the Excellence Award for Capital Structure Management for his "pioneering work on unique financing techniques."[4]

Throughout their tenure with Enron, Kenneth Lay and Jeffrey Skilling continually focused on enhancing their company's operating results. In the letter to shareholders in Enron's 2000 annual report, Lay and Skilling noted that "Enron is laser-focused on earnings per share, and we expect to continue strong earnings performance." Another important goal of Enron's top executives was increasing their company's stature in the business world. During a speech in January 2001, Lay revealed that his ultimate goal was for Enron to become "the world's greatest company."[5]

As Enron's revenues and profits swelled, its top executives were often guilty of a certain degree of chutzpah. In particular, Skilling became known for making brassy, if not tacky, comments concerning his firm's competitors and critics. During the crisis that gripped California's electric utility industry during 2001, numerous elected officials and corporate executives criticized Enron for allegedly profiteering by selling electricity at inflated prices to the Golden State. Skilling brushed aside such criticism. During a speech at a major business convention, Skilling asked the crowd if they knew the difference between the state of California and the Titanic. After an appropriate pause, Skilling provided the punch line: "At least when the Titanic went down, the lights were on."[6]

Unfortunately for Lay, Skilling, Fastow, and thousands of Enron employees and stockholders, Lay failed to achieve his goal of creating the world's greatest company. In a matter of months during 2001, Enron quickly unraveled. Enron's sudden collapse panicked investors nationwide, leading to what one *Newsweek* columnist described as the "the biggest crisis investors have had since 1929."[7] Enron's dire financial problems were triggered by public revelations of questionable accounting and financial reporting decisions made by the company's accountants. Those decisions had been reviewed, analyzed, and apparently approved by Andersen, the company's independent audit firm.

Debits, Credits, and Enron

Throughout 2001, Enron's stock price drifted lower. Publicly, Enron executives blamed the company's slumping stock price on falling natural gas prices, concerns regarding the long-range potential of electronic marketplaces such as EnronOnline, and overall weakness in the national economy. By mid-October, the stock price had fallen into the mid-$30s from a high in the lower $80s earlier in the year.

On 16 October 2001, Enron issued its quarterly earnings report for the third quarter of 2001. That report revealed that the firm had suffered a huge loss during the quarter. Even more problematic to many financial analysts was a mysterious $1.2 billion reduction in Enron's owners' equity and assets that was disclosed seemingly as an afterthought in the earnings press release. This write-down resulted from the reversal of previously recorded transactions involving the swap of Enron stock for notes receivable. Enron had acquired the notes receivable from related third parties who had invested in limited partnerships organized and sponsored by the company. After studying those transactions in more depth, Enron's accounting staff and its Andersen auditors concluded

4. E. Thomas, "Every Man for Himself," *Newsweek*, 18 February 2002, 25.
5. Eichenwald and Henriques, "Web of Details."
6. *Ibid.*
7. N. Byrnes, "Paying for the Sins of Enron," *Newsweek*, 11 February 2002, 35.

that the notes receivable should not have been reported in the assets section of the company's balance sheet but rather as a reduction of owners' equity.

The 16 October 2001, press release sent Enron's stock price into a free fall. Three weeks later on 8 November, Enron restated its reported earnings for the previous five years, wiping out approximately $600 million of profits the company had reported over that time frame. That restatement proved to be the death knell for Enron. On 2 December 2001, intense pressure from creditors, pending and threatened litigation against the company and its officers, and investigations initiated by law enforcement authorities forced Enron to file for bankruptcy. Instead of becoming the nation's greatest company, Enron instead laid claim to being the largest corporate bankruptcy in U.S. history, imposing more than $60 billion of losses on its stockholders alone. Enron's "claim to fame" would be eclipsed the following year by the more than $100 billion of losses produced when another Andersen client, WorldCom, filed for bankruptcy.

The massive and understandable public outcry over Enron's implosion during the fall of 2001 spawned a mad frenzy on the part of the print and electronic media to determine how the nation's seventh-largest public company, a company that had posted impressive and steadily rising profits over the previous few years, could crumple into insolvency in a matter of months. From the early days of this public drama, skeptics in the financial community charged that Enron's balance sheet and earnings restatements in the fall of 2001 demonstrated that the company's exceptional financial performance during the late 1990s and 2000 had been a charade, a hoax orchestrated by the company's management with the help of a squad of creative accountants. Any doubt regarding the validity of that theory was wiped away—at least in the minds of most members of the press and the general public—when a letter that an Enron accountant sent to Kenneth Lay in August 2001 was discovered. The contents of that letter were posted on numerous websites and lengthy quotes taken from it appeared in virtually every major newspaper in the nation.

Exhibit 2 contains key excerpts from the letter that Sherron Watkins wrote to Kenneth Lay in August 2001. Watkins' job title was vice president of corporate development, but she was an accountant by training, having worked previously with Andersen, Enron's audit firm. The sudden and unexpected resignation of Jeffrey Skilling as Enron's CEO after serving in that capacity for only six months had prompted Watkins to write the letter to Lay. Before communicating her concerns to Lay, Watkins had attempted to discuss those issues with one of Lay's senior subordinates. When Watkins offered to show that individual a document that identified significant problems in accounting decisions made previously by Enron, Watkins reported that he rebuffed her. "He said he'd rather not see it."[8]

Watkins was intimately familiar with aggressive accounting decisions made for a series of large and complex transactions involving Enron and dozens of limited partnerships created by the company. These partnerships were so-called SPEs or special purpose entities that Enron executives had tagged with a variety of creative names, including Braveheart, Rawhide, Raptor, Condor, and Talon. Andrew Fastow, Enron's CFO who was involved in the creation and operation of several of the SPEs, named a series of them after his three children.

SPEs—sometimes referred to as SPVs (special purpose vehicles)—can take several legal forms but are commonly organized as limited partnerships. During the 1990s, hundreds of large corporations began establishing SPEs. In most cases, SPEs

8. T. Hamburger, "Watkins Tells of 'Arrogant' Culture; Enron Stifled Staff Whistle-Blowing," *Wall Street Journal* (online), 14 February 2002.