



# From Grace to Disgrace: the Rise & Fall of Arthur Andersen

N. Craig Smith and Michelle Quirk <sup>1</sup>

*London Business School*

**Abstract.** In June 2002, Arthur Andersen LLP became the first accounting firm in history to be criminally convicted. The repercussions were immense. From a position as one of the leading professional services firms in the world, with 85,000 staff in 84 countries and revenues in excess of \$9 billion, Andersen effectively ceased to exist within a matter of months. Although Andersen's conviction related specifically to a charge of obstructing justice, public attention focused on the audit relationship between Andersen and its major client, Enron Corporation, particularly the actions (and inactions) that had allowed Enron to post spectacular year-on-year earnings and profit growth. As well as examining events leading up to the demise of Andersen, the case provides an opportunity to consider the broader controversy over accounting and corporate governance practices and, more generally, the pressures found within organisations that can foster unethical conduct. The case was prepared from public sources.

**Keywords:** accounting ethics, auditing, conflicts of interest, normative ethics, ethical decision making, corporate governance, auditor role and responsibilities.

## 1. Introduction

On 15 June 2002, Arthur Andersen LLP ("Andersen") made history by becoming the first accounting firm to be convicted of a felony when a United States district court jury found the firm guilty of obstruction of justice. The conviction related to events that had taken place between October and November 2001, both prior to and immediately following notice of an impending Securities & Exchange Commission ("SEC") investigation into Andersen's former star client Enron. These events included:

- 
1. Michelle Quirk, MBA (Dist.) prepared this case from public sources under the supervision of N. Craig Smith, Associate Professor of Marketing & Ethics, as a basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. The authors gratefully acknowledge the guidance provided on accounting standards by Ronnie Barnes, Assistant Professor of Accounting at London Business School.

- The large-scale destruction of Enron-related documents which Andersen publicly announced had taken place (the original subject of the indictment)<sup>2</sup>, and
- An internal e-mail sent by an Andersen lawyer suggesting specific alterations be made to a memo relating to earnings advice given to Enron (see Exhibit 1). This memo was a key determinant of Andersen's ultimate conviction.

It was not the first time Andersen had found itself in legal trouble. Indeed, over the preceding years, each of the Big Five accounting firms had been ordered to pay out millions of dollars to settle shareholder lawsuits filed as a result of lost value from accounting restatements (see Exhibit 2 for a summary of the largest such settlements). However, it soon became apparent that the SEC regarded Andersen as a 'serial offender' and, in the face of public (and political) outcry following Enron's collapse, was determined to make an example out of Andersen.

Enron's own problems had become evident on 16 October 2001, when the company announced it was taking a \$544 million after-tax charge against earnings related to one of its off-balance-sheet partnerships (a partnership created and managed by Enron's CFO, Andrew Fastow) and was reducing shareholders' equity by \$1.2 billion (Enron's reported total assets in 2000 were \$66 billion). On 22 October, the SEC opened an inquiry into possible conflicts of interest related to dealings between Enron and its subsidiary partnerships. This inquiry was upgraded to a formal investigation on 31 October. In November, Enron further announced that it was restating its accounts for the period 1997-2001 due to accounting errors relating to transactions with other off-balance sheet entities. Enron's downward spiral continued and on 2 December 2001, Enron filed for protection from creditors and became the largest corporate bankruptcy in U.S. history.

The impact of Enron's collapse was both profound and widespread: Enron's share price plunged from a 52-week high of \$43 on August 13, to less than \$1 by the end of 2001<sup>3</sup>; thousands of Enron employees were left facing retirement without retirement funds; questions were raised about Enron's political connections with the Bush administration and the Blair government; and global banks, investment analysts, and industry 'experts' found their reputations seriously tarnished as their involvement in the affair was discovered.

In turn, Andersen's indictment and subsequent conviction in the wake of Enron's collapse effectively rang the death knell for one of the largest and most

---

2. Grand Jury Indictment CRH 02 121: *U.S.A. v Arthur Andersen LLP*.

3. Big Charts, ENRNQ Chart, at <http://bigcharts.marketwatch.com>.

well respected accounting firms in the world. Even before the verdict in June 2002, Andersen in the U.S. was a shadow of its former self, having lost 690 of its 2,311 public company clients and 17,000 of its 27,000 employees since January of the same year.<sup>4</sup> Soon after the verdict was read, Andersen stated that it would stop auditing publicly held companies by August 31. Although promising to appeal the conviction, it was nonetheless a sad end to an audit business that Arthur Andersen had started with such good intentions almost 90 years previously.

## 2. Andersen

In 1913, a young certified public accountant named Arthur Andersen, together with fellow accountant Clarence DeLany, set up a small auditing firm in downtown Chicago. When DeLany left the firm in 1918, the firm was renamed Andersen & Company.

Andersen hired top university graduates and taught them to “think straight and talk straight.” This became a mantra within Andersen and the firm demanded the same behaviour from its clients. After the Wall Street crash of 1929 and the ensuing depression, Andersen led the way in rebuilding Americans’ faith in business as he continued to insist on honest accounting and eliminating conflicts of interest.<sup>5</sup> Public accountants should be answerable to the investing public, Andersen argued in his many writings, not to the companies they audit.<sup>6</sup>

When Andersen died in 1947, his ‘think straight and talk straight’ culture was deeply infused throughout the firm and continued under the leadership of Leonard Spacek. Business continued to grow and through the 1970s Andersen expanded its international reach and became the world’s largest professional services firm in 1979.<sup>7</sup>

Andersen was perceived as a market leader, a firm that set the standard for honest and law-abiding accounting – “*people thought there was the Andersen way – and the wrong way.*”<sup>8</sup> Inside the firm, the culture was both a proud and a cohesive one. Andersen fostered a ‘one-firm philosophy’ – even as the firm expanded globally, employees were bound into the firm through the many team building and morale raising exercises as well as the reported 135 hours a year training that each employee received.<sup>9</sup> This trend towards conformity (and particularly the training component) gave rise to the company moniker

---

4. ‘*Arthur Andersen is found guilty of obstructing justice*’ The Accountant, 21 June 2002.

5. D Babington & B Rigby ‘*Recalling Andersen’s Glory Days*’, News24.com, 16 June 2002.

6. D Babington & B Rigby ‘*In glory days, Andersen led from the front*’, from Houston Chronicle at www.chron.com, June 16 2002.

7. ‘*Analysts: It’s the end of Andersen*’ Associated Press, 15 June 2002, at www.chron.com.

8. ‘*In glory days Andersen led from the front*’, Reuters, June 16 2002.

“the Marine Corps of Accounting” and led many outsiders to label Andersen employees “Androids”.<sup>10</sup>

The merger and acquisitions boom of the 1980s represented a crucial change in the way that the accounting firms operated, with the realisation that the fees generated by the largely ‘bread and butter’ audit work paled in comparison to the potential fees to be earned from management consulting. The Big Five firms (Andersen, Deloitte, KPMG, PwC, and Ernst & Young) started aggressively undercutting each other on price for auditing services, treating them as a springboard for the more lucrative consulting contracts (see Exhibit 3).

By 1988, Andersen Consulting (Andersen’s consulting arm) was generating around 40% of the combined company profits and a rift developed between the consulting and accounting arms of the firm.<sup>11</sup> This situation was not helped when the accountants themselves formed a consultancy arm aimed at small businesses.<sup>12</sup> A bitter court battle ensued and the International Chamber of Commerce ordered Andersen Consulting to either pay \$15 billion in compensation for withholding fees or pay \$1 billion in compensation and discontinue using the Andersen name. In 2000, Andersen Consulting opted for the latter and spent \$175 million re-inventing itself as Accenture. This ‘divorce’ pitched Andersen down from the top to the fifth largest among the Big Five accounting firms.

By 2001 Andersen had grown from a small one-office firm in downtown Chicago, to a leading professional services firm with 85,000 staff spread throughout 390 offices in 84 countries, together bringing in \$9.3 billion in revenues.<sup>13</sup>

### 3. Enron<sup>14</sup>

Enron has accomplished more in its 15-year history than many of the world’s best-known companies have in a century. Why? Because Enron employees have an insatiable drive for trying the unexpected, thinking the unthinkable, and accomplishing the unattainable. We have set a new course for energy and communications in the new millennium.<sup>15</sup>

- 
9. James Arnold ‘*Tough Times for the ‘Androids’*’, BBC News, 15 June 2002, at [www.news.bbc.co.uk](http://www.news.bbc.co.uk).
  10. ‘*The Andersen Files*’ BBC Money Programme, 23 July 2002.
  11. ‘*Basic Background: Arthur Andersen*’ at [www.justpeople.com](http://www.justpeople.com), September 2001.
  12. Ibid.
  13. James Arnold ‘*Tough Times for the ‘Androids’*’, BBC News, 15 June 2002, at <http://news.bbc.co.uk>.
  14. Unless separately referenced, the dates and events in this section reflect information from ‘*Enron Timeline*’, <http://news.bbc.co.uk>; and [www.CBSNews.com](http://www.CBSNews.com), 31 July 2002.
  15. The press room at [www.enron.com](http://www.enron.com).

In 1985, Houston Natural Gas and InterNorth, a natural gas company based in Omaha, Nebraska, merged to form Enron Corp. (“Enron”), an interstate and intrastate natural gas pipeline company with 37,000 miles of pipe. Soon after the merger, Kenneth Lay, an energy economist who had previously held both academic and government positions, became Enron’s chairman and chief executive.

Over the next 15 years, Enron was to grow from a small regional natural gas company to a global energy-trading giant, the seventh largest corporation in the U.S. by reported revenues. The company became the darling of Wall St and investors and analysts lauded praise, bullish appraisals, and money on Enron and its dynamic management for its consistent innovation and growth.

Deregulation (for which Enron had been a prominent proponent), the Gulf War, and the Internet boom all played their part in Enron’s spectacular rise to prominence, a rise that saw Enron’s share price reach a high of over \$90 in August 2000. Much of Enron’s success was attributed to the decisions of Enron’s senior management, particularly Lay and Jeff Skilling, who was brought onboard in 1990 from his position as head of McKinsey & Company’s energy practice and who later become Enron’s CEO.

Skilling believed that Enron could profit from trading futures in gas contracts – effectively betting against future movements in the price of gas-generated energy. Although deregulation had arguably opened the industry to competition, it had also brought price volatility to the market, and when Enron offered to buy and sell tomorrow’s gas at a fixed price today, many suppliers and consumers seized the opportunity. Buoyed by its initial success, Enron expanded its trading operations into a myriad of other energy-related (and some non-energy related) products including oil, coal, emissions, and even weather.

A further string to Enron’s bow was EnronOnline, an online trading platform that was officially launched in November 1999. EnronOnline simplified the trade of Enron’s standardised contracts so that all a customer had to do was log on and ‘point and click’. By July 2001, online trade had increased to over 5,000 transactions (worth \$3 billion) a day. EnronOnline was a public relations coup and a clear example of why *Fortune* magazine consistently selected Enron as the most innovative company in the U.S. from 1996 to 2001.<sup>16</sup>

Internally, Skilling championed what became known as the “rank or yank” appraisal policy for employees. During Enron’s six-monthly performance reviews, each employee was ranked on a scale of (1) to (5). Those in the upper ranks (4-5) enjoyed bonuses and promotion, while those in the bottom 15% (1) could lose their jobs. Employees were given until the next review to improve their performance, however, most chose to accept severance packages rather

---

16. P. Fusaro & R. Miller ‘*What Went Wrong at Enron*’ John Wiley & Sons 2002 at p.74-76.

than risk the chance of being ‘yanked’ at a later date. In addition, employees in categories (2) and (3) were put on notice that they were at risk of being yanked in the future – this effectively meant that 50% of Enron’s staff were at serious risk of losing their jobs at any given time.<sup>17</sup>

According to former Enron employees, this rating system led to a “super-charged” competitive culture, a culture that incentivised employees to make as much money as possible for the company.<sup>18</sup> Indeed, it was Lay himself who best described Enron’s view of its employees, when in a statement to shareholders in the 1999 Enron Annual Report, he stated that “*individuals are empowered to do what they think is best ... we do, however, keep a keen eye on how prudent they are ... we insist on results*”.<sup>19</sup>

With annual reported global revenues of \$100 billion and earnings up 40% over three years, 2000 was a great year for Enron and for Enron executives and directors, whose compensation and bonuses allowed them a life of undreamed of luxury. However, this was not to continue indefinitely. On 14 August 2001 Skilling resigned as CEO, citing personal reasons. His departure came as a shock to investors, who began to worry that all was not as it seemed.

On 16 October, an accounting oversight relating to an off-balance sheet partnership forced Enron to disclose a \$544 million third-quarter after-tax loss and a \$1.2 billion reduction in shareholder equity. The SEC announced an inquiry into a possible conflict of interest relating to transactions between Enron and its subsidiary partnerships (Enron’s CFO Andrew Fastow was also managing a number of these companies), and on October 31, the SEC inquiry was upgraded to a formal investigation.

Enron admitted that it had overstated earnings by almost \$600 million since 1997 and was forced to restate profits for that period. Concerns about the company’s financial problems continued to drive Enron’s share price down. At the same time, Enron employees, whose 401(k) accounts were filled with Enron stock, were unable to cash out due to a lock out period imposed after Enron had changed its 401(k) administrator. By the time the ban was lifted, Enron’s share price had fallen to less than \$10 and thousands of Enron employees had watched their retirement funds virtually disappear.

On November 8, Enron reached agreement to enter into a merger with rival energy company Dynegy. However, on November 28 Dynegy pulled out of the deal, claiming that Enron had breached a number of warranties and covenants in the merger agreement.<sup>20</sup> Standard & Poors downgraded Enron to a B-minus status causing a liquidity crisis for Enron as its access to some \$3 billion in cheap short-term money was lost.<sup>21</sup> Less than a week later Enron was forced

---

17. Ibid. at p.51.

18. ‘*Inside the Enron Scandal*’ BBC Money Programme, 4 April 2002.

19. ‘*What Went Wrong at Enron*’ at p.47.

20. *Enron Timeline*, Platts Energy Economist, www.platts.com.

21. ‘*Why Enron Crashed*’, Platts Energy Economist, April 2002, at www.platts.com.

to file for protection from creditors in a Chapter 11 bankruptcy application. The New York Stock Exchange suspended trading of Enron shares on 15 January 2002 and moved to delist the stock.

#### 4. Back to Basics: What Actually Happened?

Oh what tangled webs we weave, when first we practice to deceive.<sup>22</sup>

The roots of the legal case against Andersen were to be found in the growing financial problems within Enron during 2001, problems largely tied up in the web of off-balance sheet partnerships created by Enron CFO Andrew Fastow. Prior to Enron's bankruptcy in December 2001, approximately 3,500 of these partnerships were responsible for keeping between \$15-20 billion of debt off Enron's books.<sup>23</sup>

However, Enron had long been pushing the interpretation of accounting rules to its limits and as Enron's auditor for over 16 years, Andersen found itself increasingly caught up in the emerging scandal.

#### 5. Enron: a History of Creative Interpretation?

Enron is a company that deals with everyone with absolute integrity. We play by all the rules; we stand by our word. We want people to leave a transaction with Enron thinking that they've been dealt with in the highest possible way as far as integrity and truthfulness.<sup>24</sup>

##### 5.1. Mark-to-Market Accounting

During 1990, fuelled by the energy shortages created by the Gulf War, Enron's earnings soared. As growth slowed through 1991, Enron bosses had to find new ways to meet aggressive growth targets. Using ambiguous accounting rules in increasingly creative ways was to become the tool for achieving Enron's earnings objectives.

The problem of how to value assets and when to realise associated gains and losses was not a new one. The traditional approach was conservative accounting; recognising a decrease in value when it occurred and an increase in value once the asset was sold. In contrast, under the mark-to-market

22. Sir Walter Scott from "*Marmion*".

23. Rupert Cornwell '*Pressure builds for reforms after Senate finds Enron directors knew of crisis*': The Independent, 8 July 2002.

24. Kenneth Lay, extract from Enron promotional video, included in '*Inside the Enron Scandal*' BBC Money Programme, 4 April, 2002.

(“MTM”) approach (known as “Current Cost Accounting” in the United Kingdom), assets were regularly revalued, with any increase or decrease in value recorded in the income statement and balance sheet for the relevant financial year.

The problem with MTM accounting was that in the absence of a price-setting market for the asset, values were ambiguous (U.S. GAAP required such assets to be accounted for on a ‘fair value’ basis). This ambiguity certainly existed with Enron, where there was no objective way to price the various (and often ‘first to market’) commodity trades that made up much of Enron’s business. In response to this ambiguity, Enron created a range of complex forward pricing models based on internally generated assumptions in order to value the thousands of (largely intangible) assets on its books.<sup>25</sup> Enron was thus creating a potential monster: the ability to manufacture seemingly solid (albeit mostly non-cash) profits, which Wall Street was willing to capitalise with dot.com growth multiples of forty times expected earnings.<sup>26</sup>

The standard to which company auditors were required to measure the application of MTM accounting in any particular case was that of “reasonableness”, a term that clearly left significant scope for interpretation. As Enron’s auditors, Andersen was effectively the primary judge of what was to be considered “reasonable” and what was not.

One of Enron’s first deals involving MTM accounting occurred in 1991 when Enron brokered a 20-year deal to supply a power station in New York State. Rather than reporting profits on a year-by-year basis, Enron booked all 20 years’ worth of *estimated* profits in one financial year. As one commentator observed, this was equivalent to Enron “placing a huge bet and telling the world they’d already won.”<sup>27</sup>

Apart from the fact that the use of MTM accounting was intended for much shorter term application, Enron’s interpretation was all the more aggressive because it used its own estimates about expected revenues and profits, estimates that were often arbitrary or made up. Enron also failed to disclose to the SEC that its use of MTM accounting had a material impact on annual earnings (in fact, the New York power deal had contributed almost 50% of Enron’s profit growth for the year).<sup>28</sup> Nonetheless, Andersen signed off on the accounts, analysts recommended the stock, and Enron’s share price and bonus pool continued to rise.

As Enron executives became addicted to rapid growth, their eyes turned to new sources of revenue. Trading in energy commodities was an attractive choice. Although industry regulators considered introducing controls over

---

25. ‘What Went Wrong At Enron’ at pp.35-6.

26. ‘Why Enron Crashed’ Platts Energy Economist, April 2002, at [www.platts.com](http://www.platts.com).

27. ‘Inside the Enron Scandal’ BBC Money Programme, 4 April, 2002.

28. *Ibid.*

these new and largely speculative markets, they ultimately decided not to interfere, leaving the market players to police themselves.

In the meantime, Enron bosses in the U.K. were starting to feel the pressure from their U.S. bosses to “tweak the knob”.<sup>29</sup> By changing various accounting assumptions, Enron was able to show sustained earnings and profit growth, earning Enron executives tens of millions of dollars in bonuses and share sales.

By the late 1990s, the situation was getting more precarious. Despite appearances, Enron was facing ballooning debts and the fear that the facade might crumble was very real (it was only the presumption of credit-worthiness that allowed Enron to act as counterparty in its many derivatives trades<sup>30</sup>). Persuading the ratings agencies that the huge debts being incurred were really ‘non-recourse’ to Enron was critical and became a single-minded preoccupation for Lay and Skilling.<sup>31</sup> Rather than face reality, Andrew Fastow suggested an extremely aggressive alternative: by creating a series of off-balance sheet partnerships, Enron’s debts could effectively be concealed from the world at large. These partnerships were approved by both Fastow’s bosses and by Enron’s Board of Directors, who had to waive Enron’s code of conduct to get around the potential conflict of interest caused by putting Fastow in charge of the subsidiary partnerships (see Exhibit 4 for extract from Enron’s Code of Ethics).<sup>32</sup>

## 5.2. Special Purpose Entities (“SPEs”)

The use of SPEs was by no means a new development and had been a common mechanism for securitising various asset portfolios for years. Asset securitisation typically involved the transfer of on-balance sheet assets (such as mortgages) to a third party or a trust, who would create securities out of those assets and issue certificates or notes to investors. The cash flows from the assets (for example, mortgage repayments) were used to fund repayments to investors. Among other benefits, securitisation allowed institutions such as banks the ability to transfer risk, improve financial performance ratios, and access alternative funding sources.<sup>33</sup>

The transfer of financial assets through an SPE enabled an originator to remove assets (or a portion thereof) from its balance sheet if ‘control’ over those

---

29. Ibid.

30. ‘*Why Enron Crashed*’ Platts Energy Economist, April 2002, at [www.platts.com](http://www.platts.com).

31. Ibid.

32. ‘*Report links Enron directors to questionable key decisions*’, New York Times, 18 Jan 2002.

33. ‘*Interagency Guidance on Asset Securitization Activities*’ [www.federalreserve.gov/boarddocs/SRLETTERS/1999/sr9937a1.pdf](http://www.federalreserve.gov/boarddocs/SRLETTERS/1999/sr9937a1.pdf).

assets was surrendered. Financial Accounting Standard 140 (previously FAS125) required three tests to be satisfied to meet this ‘control’ threshold:<sup>34</sup>

- That the transferred assets (or liabilities) had been put out of reach of the transferor and its creditors (even in bankruptcy or other receivership),
- That each transferee had the right to pledge or exchange the transferred assets, and
- The transferor did not maintain effective control over the transferred assets (e.g. through an agreement allowing the transferor to repurchase or redeem the assets).

Enron’s increased use of SPEs was due to its unique position in the newly deregulated energy markets – unlike a stock exchange where most trades are made directly between a buyer and a seller and the exchange merely acts as an intermediary, Enron served as the counterparty to each trade that passed through its ‘market’. By Wall Street standards, however, Enron’s lack of hard assets and its large debts made its position as counterparty vulnerable because of the risk that it might default on its obligations – any downgrade of its credit rating could therefore have put Enron out of business as a market maker.<sup>35</sup>

SPEs provided the vehicle by which Enron could hedge its exposure as counterparty, entering into numerous derivative transactions with these subsidiary partnerships (most notably LJM, LJM2 and Raptors I, II, and III).<sup>36</sup> In an interview with *CFO* magazine in mid 1999, Fastow described how almost \$1 billion in debt was kept off Enron’s balance sheet through this complex and innovative arrangement – “*what we did...is we set up a trust, issued Enron Corp. shares into the trust and then the trust went to the capital markets and raised debt against the shares in the trust, using the shares in the trust as collateral.*”<sup>37</sup> Enron’s use of SPEs (and MTM accounting) was disclosed in the notes to its consolidated financial statements. (See Exhibit 5 for more on Enron SPEs.)

The problem was that these types of transactions carried a high level of risk (that Enron’s stock price and asset value could both fall – which they ultimately did). While risk alone was not the problem, it appeared that certain loan guarantees supplied by Enron to its SPEs were triggered when Enron’s

---

34. Financial Accounting Standards Board Statement No. 140 (replaced Statement No. 125) relating to accounting for transfers and servicing of financial assets and extinguishments of liabilities. Refer to [www.fasb.org](http://www.fasb.org) for the FASB summary of Statements 125 and 140.

35. *What Went Wrong at Enron* at p.63-4.

36. *What Went Wrong at Enron* at p.63-4.

37. Ronald Fink ‘*What Andrew Fastow Knew*’, *CFO Magazine*, Jan 1 2002, at [www.cfo.com](http://www.cfo.com).

stock price fell below a pre-specified level.<sup>38</sup> Thus, the deals were not really non-recourse to Enron at all.

In the latter stages of 2001, it was discovered that (a) two Raptor partnerships had insufficient credit to pay Enron on its hedges and (b) another SPE (Chewco) had failed to meet the 3% ownership threshold required to keep its accounts off Enron's consolidated accounts, and Enron was forced to consolidate - the complex web began to unravel. In the meantime, transactions between Enron and Fastow's partnerships had boosted Enron's reported financial results by more than \$1 billion, enriching Fastow and other managers by millions of dollars in the process.<sup>39</sup>

## 6. The Role of the Auditor in the Prevention and Detection of Business Fraud

When fraud is alleged or discovered within a business, the initial response is generally "how could it have happened?" If audited financial statements were issued, the question becomes "why didn't the auditors notice?" The question of whose responsibility it is to prevent and detect crime has been brought sharply into focus following Enron's collapse and has sparked significant debate concerning the differences between the role of the external auditor and the public's perception of that role (sometimes referred to as the 'expectations gap').

The Auditing Standards Board issues Statements on Auditing Standards ("SAS"). One of the most important provisions governing auditors is to be found in Section 110 of SAS No. 1, *Responsibilities and Functions of the Independent Auditor*:

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence, and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are not material to the financial statements are detected.

SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, provides auditors with operational guidance on the consideration of fraud when a financial statement audit is conducted. SAS No. 82 requires the assessment of the risk of material misstatement and consideration of around 40

---

38. Prof. Steven Schwarcz 'Lessons from Enron: The Use & Abuse of Special Purpose Entities in Corporate Structures', talk delivered at Duke University, 8 Feb 2002.

39. *What Went Wrong at Enron* at p.171.

specific fraud risk factors. These include management, industry, and operational characteristics. Specifically, auditors are required to make inquiries of management concerning the possible risk of fraud and to document in the workpapers any identified risk factors as well as their response for these risk factors (see Exhibit 6 for extract from Practitioner's Guide to Generally Accepted Auditing Standards ("GAAS")). See Exhibit 7 for Andersen's statement to Enron's shareholders and Board of Directors (from Enron's Annual Report).

## 7. The Andersen Indictment

Enron robbed the bank, Arthur Andersen provided the getaway car, and they say you were at the wheel.<sup>40</sup>

Andersen was Enron's auditor for 16 years, bringing in \$52 million in fees from the Enron account in 2000 alone. Approximately 50% of those fees came from Andersen's audit role; the remaining 50% was derived from other consulting (such as taxation) services.<sup>41</sup> The nature of the relationship between auditor and audited appeared close, illustrated by the fact that David Duncan (the Andersen partner in charge of the Enron account) and his 100-strong team worked out of Enron's Houston offices. In addition around 300 middle and senior managers at Enron were ex-Andersen employees.<sup>42</sup>

Given the public outcry following Enron's spectacular collapse, few were surprised that investigators knocked on Andersen's door. Although questions and intense interest surrounded Andersen's audits of Enron's financial statements and possible conflicts of interest that may have led Andersen to 'turn a blind eye' to some of Enron's dealings, those audits were *not* the subject of Andersen's indictment. Issues surrounding that auditing role did, however, catalyse debate on the role and responsibilities of auditors more generally.

As Enron's financial problems intensified in 2001, a number of discussions between Enron and its auditors took place. During one such discussion, Andersen disagreed with Enron's characterisation of a \$1 billion loss as 'non-recurring'. Following that discussion, Andersen lawyer Nancy Temple sent an e-mail to Duncan recommending that her name and reference to legal consultation be deleted from the earlier memo recording the events (see Exhibit 1).

---

40. Congress questioning of David Duncan, the Andersen partner in charge of the Enron audits: 'The Andersen Files', BBC Money Programme, 23 July 2002.

41. 'Why Enron Crashed' Platts Energy Economist, April 2002, at <http://www.platts.com>.

42. Nick Cohen 'Without Prejudice: Half-baked bean counters: UK accountancy scams could never happen in Britain, they say: Don't believe it for a moment': The Observer, 7 July 2002.

Another earlier e-mail, sent by Temple on 12 October (before the SEC had started its inquiry into Enron) also contributed to the indictment. That e-mail was sent to Michael Odum, Andersen's risk management partner for the Houston office, and stated that "it would be helpful" if members of the Enron audit team made sure that they were in compliance with a document-retention policy that required destruction of records other than audit-related work papers, consistent with industry practice (see Exhibit 8). Those two e-mails later served as a red flag for the Department of Justice, who saw them as a clear attempt to tamper with documents during an SEC investigation.<sup>43</sup>

According to the official indictment, on 22 October Andersen partners assigned to the Enron engagement team (including Duncan) ordered the wholesale destruction of Enron-related documents. Over the next few weeks, tons of physical files were shredded and computer files deleted. It was only on November 8, when Andersen was served with official notice of the SEC investigation that the shredding stopped (refer to Exhibit 9 for Temple's memo to the Enron engagement team following this notice). Andersen was subsequently charged with obstruction of justice.

Andersen had volunteered in a statement in January 2002 that its Houston office had disposed of a "significant but undetermined number of Enron-related documents" during the SEC investigation. This release of information was consistent with a policy of openness followed by Joe Berardino, Andersen's CEO, during investigations of Andersen's role in Enron's collapse. In an article in the *Wall Street Journal* in December 2001, he had pledged: "We are co-operating fully with investigations into Enron. If we have made mistakes, we will acknowledge them. If we need to make changes, we will." Later that month, Berardino told a Congressional hearing that his firm had erred in the audit of one of the off-balance-sheet partnerships at the centre of the accounting controversy.

In order to convict Andersen of the charge of obstruction of justice, the jury had to find that someone within Andersen 'corruptly persuaded' someone else to destroy documents or alter documents with the purpose of impeding the SEC's investigation. The government argued there were several such persuaders; the defence argued there were none. The jury found that Temple, by dictating the edits in the memo, was the 'corrupt persuader' and Andersen as a firm was convicted of the charge.<sup>44</sup> (See Exhibit 10 for timeline, October 2001 to June 2002).

---

43. Cathy Thomas, Deborah Fowler 'Called to Account' Time South Pacific 24 June 2002 Issue 24 p.66.

44. 'Arthur Andersen: Called to Account' on Online News Hour, [www.pbs.org/newshour](http://www.pbs.org/newshour), 17 June 2002.

## 8. Who was involved?

### 8.1. At Andersen

The wonderful thing about Andersen is that it could do so much wrong without ever knowing it. It could certify Enron's books for years, and even after Enron admitted its numbers were false, Andersen didn't know it had done wrong. It could shred and delete thousands of Enron-related documents without knowing that was wrong either. Maybe that was Andersen's problem: It seems so much better at not knowing than it was at knowing.<sup>45</sup>

This was not the first time Andersen or the other Big Five firms had found themselves in trouble following accounting restatements by their audit clients. Indeed, Ernst & Young, PwC, and KPMG had, like Andersen, paid out millions of dollars to settle shareholder lawsuits following such restatements (see Exhibit 2).

However, on this occasion, it appeared that the SEC considered Andersen a 'serial offender' and even though the case was not strictly to do with any alleged negligence by Andersen in its audits of Enron financial statements, Andersen's actions in relation to Enron-related documents, and the culpability that those actions implied (in terms of interfering with the SEC investigation) proved to be the final straw.

Whilst Andersen was convicted as a firm, there had been several attempts within Andersen to bring Enron back into line in its use of accounting standards. Internal Andersen documents released by a U.S. house committee (mostly comprising e-mails between Andersen technical experts in Chicago and members of the Enron engagement team in Houston), indicate that Carl Bass, an Andersen partner in the Professional Standards Group, had argued against Enron's interpretation of accounting rules for up to two years before Enron's problems were made public. Bass had expressed a number of concerns about deals between Enron and its SPEs and had argued that various transactions fell outside the rules and should be consolidated into Enron's statements (See Exhibit 11).<sup>46</sup> Enron demanded Bass's removal from the engagement team – Bass told congressional investigators that he was removed from the Enron account in March 2001 because he had refused to 'rubber stamp' many of Enron's most aggressive accounting manoeuvres.<sup>47</sup>

---

45. Dan Ackman, '*Andersen Guilty; Enron still Unindicted*', Forbes.com, 17 June 2002.

46. The full pack of released documents (95 pages) can be found at: <http://energycommerce.house.gov/107/pubs/EnronDocumentsApril2.pdf>.

47. '*Enron Documents Indicate Possible Cover-Up*', Forbes.com 3 April 2002.

## 8.2. At Enron

From the start, Enron's top management surrounded themselves with other smart and driven people, many of whom had advanced degrees in business, economics, and finance. A fiercely competitive culture in which the rewards of success were potentially huge, helped create the environment of 'innovation and aggression' that Lay and Skilling believed was necessary to grow Enron into the powerhouse they wanted it to be.

As Enron's reported earnings and share price boomed, Enron executives reaped hundreds of millions of dollars in salary, cash bonuses, and share options. Even as Enron headed into bankruptcy in the latter stages of 2001, senior Enron employees received \$100 million in cash bonuses for the year. And as Enron employees found themselves unable to sell their own shares (in their 401(k) accounts), senior executives, in particular Lay and Skilling, continued to sell off their own holdings for millions of dollars. Between 1999-2001 alone, Lay was estimated to have grossed \$247 million in salary and share sales.<sup>48</sup>

What became apparent after Enron's collapse was the serious breakdown in corporate governance that had occurred at Enron. Paid as much as \$350,000 per year (more than twice the average remuneration for directors on the boards of the 200 largest U.S. companies<sup>49</sup>), Enron's non-executive directors appeared to turn a blind eye to many of the questionable activities undertaken by management.

An example of this occurred in February 1999, when David Duncan described Enron's accounting practices to the audit committee of Enron's Board of Directors ("the Audit Committee") as "high risk" and "pushing limits". Despite similar warnings through 1999-2001, not one director on the committee (including a former Stanford accounting professor) objected to the use of these procedures, asked for a second opinion, or demanded a more prudent approach.<sup>50</sup>

A six-month Senate investigation also discovered other events that further illustrated the apparent failure of Enron's Board of Directors ("the Board"), and its various oversight committees, to fulfil its duty of care to investors:<sup>51</sup>

- During 2000, the Board's compensation committee approved \$750 million in cash bonuses to Enron executives. This was in a year

---

48. Ien Cheng 'Executives in top US collapses made \$3.3 billion' FT.com 30 July 2002.

49. Rupert Cornwell 'Pressure builds for reforms after Senate finds Enron directors knew of crisis' The Independent 8 July 2002.

50. John Byrne 'No Excuses for Enron's Board', *Special Report: The Angry Market*, Business Week 29 July 2002, Issue 3793, at p. 50.

51. Ibid.

where total reported net income amounted to \$975 million – apparently no one added up the numbers.

- The Board approved a credit line of \$7.5 million for CEO Lay that allowed him to not only borrow shareholder funds for his personal use, but which also allowed him to repay those loans with Enron stock. It was later revealed that in the 12 months preceding Enron’s collapse, Lay drew down \$77 million in cash from the facility and repaid it with Enron shares.
- The Board waived Enron’s code of ethics to accommodate Fastow’s SPE partnerships – an event that even the directors belatedly agreed was “a red flag the size of Alaska”.<sup>52</sup>
- In August 2001, Sherron Watkins (a corporate development executive at Enron) sent a letter to Lay expressing concern over accounting irregularities that she believed could pose a threat to Enron. However, when Enron’s lawyers first mentioned the letter to the Board, the actual document was not shown to the Board and no one asked for either her name or for a copy of the letter.

### 8.3. Wall Street

“*No one likes a good growth story better than Wall Street.*”<sup>53</sup> Through the 1990s Enron gave Wall Street exactly what it wanted and in return Wall Street turned Enron into a star and in the process helped make its executives rich beyond their wildest dreams. Enron’s collapse soon stirred up debate over Wall Street’s involvement, particularly over the dual role played by the large investment banks - as Enron’s banker on the one hand; and “as stock analysts whipping up enthusiasm” for Enron’s stock on the other.<sup>54</sup>

Enron’s top management had made it clear to the banks from the start that their analysts *had* to recommend its shares in order to get the deals (at least one analyst was fired for not doing this). Those favoured banks (including Merrill Lynch, Citigroup, and JP Morgan) went on to reap millions of dollars in fees for making and syndicating loans to Enron’s many SPEs.<sup>55</sup> As Platts Energy Economist put it:

---

52. Ram Charan et al ‘*Why Companies Fail*’ Fortune (Asia) 27 May 2002, Vol 145 Issue 11 p. 36.

53. Ibid.

54. Darren Puscas ‘*A Few Points for Clearer Understanding*’ Polaris Institute at [www.polarisinstitute.org](http://www.polarisinstitute.org), 4 Feb 2002.

55. ‘*Why Enron Crashed*’ Platts Energy Economist, April 2002, at [www.platts.com](http://www.platts.com).

If Enron and Andersen created the monster, the banks force-fed it with billions of dollars of credit, mustering money from other banks all over the world.<sup>56</sup>

#### 8.4. Politicians

Another story to emerge from the scandal surrounding Enron's collapse was the extent of Andersen and Enron's political connections, both in the U.S. and the U.K. As well as being one of President Bush's top financial backers (donating \$212,825 to Bush between 1998-2002), Andersen also spent \$6 million lobbying the U.S. government on such issues as electricity deregulation and self-regulation for the accounting profession. Andersen lobbied particularly strongly against former SEC Chairman Arthur Levitt's proposal to restrict the amount of non-audit-related work that firms like Andersen could do for clients, though it was not the only accounting firm to lobby against this initiative.<sup>57</sup>

Enron also had extensive political access, particularly in the U.S, where Enron had substantial influence on Vice President Dick Cheney's energy policy, having met with Cheney or his aides at least six times in 2001 alone. It was Enron's use of this political influence that was heavily criticised by many commentators – one example occurred in 2001 when it was revealed that Cheney and others tried to use their political muscle to help Enron sell its interest in the Dabhol Power Plant in India for \$2.3 billion. Enron was facing non-payment by the Indian government, which was disputing Enron over power prices. In addition, when local villagers protested about the construction of a power plant because of its threat to the environment and their livelihood, Enron paid state forces to quash the dissent, with many villagers severely beaten. Events like that led to Enron becoming the only company in history to be the subject of a full Amnesty International Report.<sup>58</sup>

### 9. Postscript

In 2002, WorldCom replaced Enron as the biggest ever U.S. corporate bankruptcy following revelations of an estimated \$11 billion fraud. Operating expenses had been booked as capital expenditures, inflating reported income

---

56. Ibid.

57. John Dunbar; Nathaniel Heller 'Administration Ties to Arthur Andersen Nearly as Tight as Those to Enron': The Center for Public Integrity at [www.public-i.org](http://www.public-i.org), 16 Jan 2002.

58. Darren Puscas 'A Few Points for Clearer Understanding' Polaris Institute at [www.polarisinstitute.org](http://www.polarisinstitute.org), 4 Feb 2002. Source: <http://energycommerce.house.gov/107/pubs/EnronDocumentsApril2.pdf>.

and putting WorldCom in profit for at least two years when it was in fact losing money. WorldCom's auditor was Arthur Andersen.

**Exhibit 1**  
**E-Mail From Nancy Temple To David Duncan**

To: David B. Duncan  
Cc: Michael C. Odom@ANDERSEN WO: Richard Corgci@ANDERSEN  
WO  
BCC:  
Date: 10/16/2001 08:39 PM  
From: Nancy A. Temple  
Subject: Re: Press Release draft  
Attachment: ATT&ICIQ: 3rd qtr press release memo.doc

Dave - Here are a few suggested comments for consideration.

I recommend deleting reference to consultation with the legal group and deleting my name on the memo. Reference to the legal group consultation arguably is a waiver of attorney-client privileged advice and if my name is mentioned it increases the chances that I might be a witness, which I prefer to avoid.

I suggested deleting some language that might suggest we have concluded the release is misleading.

In light of the “non-recurring” characterization, the lack of any suggestion that this characterization is not in accordance with GAAP, and the lack of income statements in accordance with GAAP, I will consult further within the legal group as to whether we should do anything more to protect ourselves from potential Section 10A issues.

Nancy

Source: HoustonChronicle.com





## **Exhibit 4**

### **Extracts from Enron's Code of Ethics**

#### **Foreword**

As officers and employees of Enron Corp., its subsidiaries, and its affiliated companies, we are responsible for conducting the business affairs of the companies in accordance with all applicable laws and in a moral and honest manner.

To be sure that we understand what is expected of us, Enron has adopted certain policies, with the approval of the Board of Directors, which are set forth in this booklet...

We want to be proud of Enron and to know that it enjoys a reputation for fairness and honesty and that it is respected. Gaining such respect is one aim of our advertising and public relations activities, but no matter how effective they may be, Enron's reputation finally depends on its people, on you and me. Let's keep that reputation high.

July 1, 2000  
Kenneth L. Lay  
Chairman and Chief  
Executive Officer

#### **Conflicts of Interests, Investments, and Outside Business Interests of Officers and Employees**

Employees of the Company have inquired from time to time as to the propriety of their association with, or the investment of their personal funds in, business enterprises similar in character to certain activities of the Company. In response, the Company has established certain principles for the guidance of officers and employees with respect to personal business and investment interests.

The primary consideration of each full-time (regular as well as temporary) officer and employee should be the fact that the employer is entitled to expect of such person complete loyalty to the best interests of the Company and the maximum application of skill, talent, education, etc., to the discharge of his or her job responsibilities, without any reservations. Therefore, it follows that no full-time officer or employee should:

- (a) Engage in any outside activity or enterprise which could interfere in any way with job performance;
- (b) Make investments or perform services for his or her own or related interest in any enterprise under any circumstances where, by reason of the nature of the business conducted by such enterprise, there is, or could be, a disparity or conflict of interest between the officer or employee and the Company; or
- (c) Own an interest in or participate, directly or indirectly, in the profits of any other entity which does business with or is a competitor of the Company, unless such ownership or participation has been previously disclosed in writing to the Chairman of the Board and Chief Executive Officer of Enron Corp. and such officer has determined that such interest or participation does not adversely affect the best interests of the Company.

Notwithstanding any provision to the contrary in this Policy on Investments, securities of publicly owned corporations which are regularly traded on the open market may be owned without disclosure if they are not purchased as a result of confidential knowledge about the Company's operations, relations, business, or negotiations with such corporations.

If an investment of personal funds by an officer or employee in a venture or enterprise will not entail personal services or managerial attention, and if there appears to be no conflict or disparity of interest involved, the following procedure nevertheless shall be followed if all or any part of the business of the venture or enterprise is identical with, or similar or directly related to, that conducted by the Company, or if such business consists of the furnishing of goods or services of a type utilized to a material extent by the Company:

- (a) The officer or employee desiring to make such investment shall submit in writing to the Chairman of the Board and Chief Executive Officer of Enron Corp. a brief summary of relevant facts; and
- (b) The Chairman of the Board and Chief Executive Officer of Enron Corp. shall consider carefully the summary of relevant facts, and if he concludes that there appears to be no probability of any conflict of interest arising out of the proposed investment, the officer or employee shall be so notified and may then make the proposed investment in full reliance upon the findings of the Chairman of the Board and Chief Executive Officer of Enron Corp.

In the event the Chairman of the Board and Chief Executive Officer of Enron Corp. should desire to make such an investment, he may do so only upon approval of the

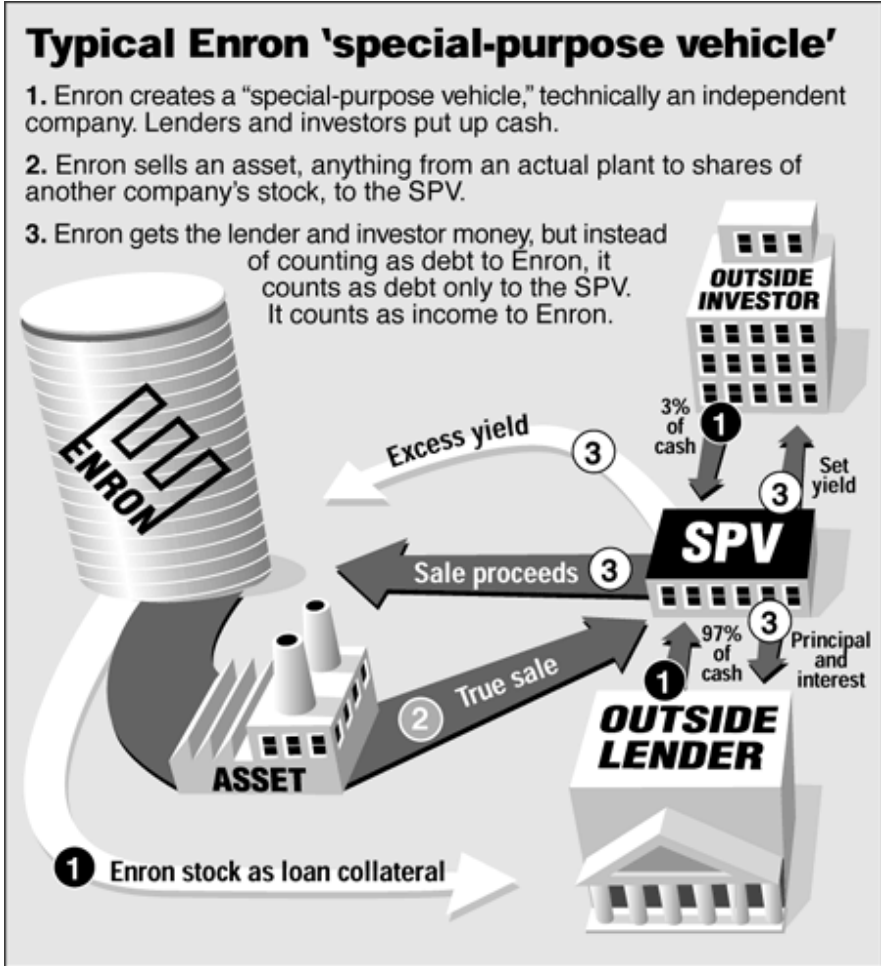
majority of a quorum of the Executive Committee of the Board of Directors of Enron Corp., other than himself at any regular or special meeting of such a Committee.

Every officer and employee shall be under a continuing duty to report, in the manner set forth above, any situation where by reason of economic or other interest in an enterprise there is then present the possibility of a conflict or disparity of interest between the officer or employee and the Company. This obligation includes but is not limited to (1) any existing personal investment at the date of promulgation of this policy, (2) any existing personal investment at the time of employment of any officer or employee by the Company, and (3) any existing personal investment, whether or not previously approved, which may become in conflict with the provisions of this policy because of changes in the business of the Company or changes in the business of the outside enterprise in which investment has been made.

In the event of a finding by the Chairman of the Board and Chief Executive Officer of Enron Corp. (or by the Executive Committee of the Board of Directors of Enron Corp., if applicable) that a material conflict or disparity of interest does exist with respect to any existing personal investment or an officer or employee, then, upon being so notified, the officer or employee involved shall immediately divest himself or herself of such interest and shall notify the Chairman and Chief Executive Officer of Enron Corp. (or the Executive Committee, if applicable) in writing that he or she has done so.

Source: [www.thesmokinggun.com](http://www.thesmokinggun.com)

### Exhibit 5 Enron Special Purpose Vehicles



Robert Dibrell / Chronicle

## Exhibit 6

### Extract from Practitioner's Guide to Generally Accepted Auditing Standards (GAAS)

#### EFFECTIVE DATE AND APPLICABILITY

Original

Pronouncements: Statement of Auditing Standards (SAS). 1, November 1972; SAS 5, July 1975; SAS 25, November 1979; SAS 41, April 1982; SAS 43, August 1982; SAS 78, December 1995; SAS 82, February 1997.

Effective Date: When issued, November 1972, except for amendments on quality control (November 1979), services other than audits of financial statements (August 31, 1982), and consideration of fraud (February 1979).

Applicability: All audits in accordance with generally accepted auditing standards and other services covered by SASs.

*NOTE: All sections apply whether the financial statements are presented in conformity with GAAP or OCBOA unless otherwise noted.*

#### FUNDAMENTAL REQUIREMENTS

##### OBJECTIVE OF ORDINARY AUDIT

To express an opinion on the fairness, in all material aspects, with which the financial statements present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles or another comprehensive basis of accounting.

#### AUDITORS RESPONSIBILITIES

In every audit, the auditor has to obtain reasonable assurance about whether the financial statements are free of material misstatement. Material misstatement includes

1. Material error. (See Section 312)
2. Material fraud. (See Section 316)
3. Certain illegal acts. (See Section 317)

#### MANAGEMENT RESPONSIBILITIES

The fairness of the representations made through financial statements is an implicit and integral part of management's responsibility. Management is responsible for

1. Adopting sound accounting policies.
2. Establishing and maintaining internal control that will, among other things, record, process, summarize, and report financial data that are consistent with management's assertions embodied in the financial statement.

The auditor's participation in preparing financial statements does not change the character of the statements as representations of management. In brief, management is responsible for the financial statements; the auditor is responsible for expressing an opinion on those financial statements.

#### GENERALLY ACCEPTED AUDITING STANDARDS

The generally accepted auditing standards (GAAS) approved by the American Institute of Certified Public Accountants (AICPA) membership are

##### A. General Standards

1. **Training and Proficiency.** The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. **Independence.** In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. **Due Care.** Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.

**B. Fieldwork Standards**

4. **Planning and supervising.** The work is to be adequately planned, and assistants, if any, are to be properly supervised.
5. **Internal control.** A sufficient understanding of internal control is to be obtained to plan the audit and determine the nature, timing, and extent of tests to be performed.
6. **Evidential matter.** Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

**C. Reporting Standards**

7. **GAAP.** The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
8. **Consistency.** The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
9. **Disclosure.** Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
10. **Reporting obligation.** The report shall contain either an expression of opinion regarding the financial statements taken as a whole or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons should be stated. In all cases where an auditor's name is associated with financial statements, the reports should contain
  - a. A clear-cut indication of the character of the auditor's work, if any.
  - b. The degree of responsibility the auditor is taking.

*NOTE: Materiality and audit risk underlie the application of all standards (see Section 312).*

**OTHER SERVICES**

The preceding 10 formal standards apply to all other services covered by SASs unless they are clearly not relevant or the SAS specifies that they do not apply.

Source: Practitioner's Guide to GAAS

**QUALITY CONTROL STANDARDS**

A firm of certified public accountants (CPAs) should establish quality control policies and procedures to provide it with reasonable assurance of conforming with GAAS in its audit engagements.

**TRAINING AND PROFICIENCY**

The auditor holds out himself as one who is proficient in accounting and auditing. Attaining proficiency begins with formal education and extends through later experience. The auditor must be aware of and understand new authoritative pronouncements on accounting and auditing.

**INDEPENDENCE**

To be independent, the auditor must be intellectually honest; to be **recognised** as independent, he or she must be free from any obligation to or interest in the client, its management, or its owners. For specific guidance, the auditor should look to AICPA and the state society rules of conduct and, if relevant, the requirements of the Securities and Exchange Commission (SEC) and the Independence Standards Board.

**DUE CARE**

The auditor should observe the standards of fieldwork and reporting, possess the degree of skill normally possessed by other auditors, and should exercise that skill with reasonable care and diligence. The auditor should also exercise professional scepticism, that is, an attitude that includes a questioning mind and a critical assessment of audit evidence. However, the auditor is not an insurer and the audit report does not constitute a guarantee because it is based on reasonable assurance.

**INTERPRETATIONS**

There are no interpretations for this section.

**Exhibit 7****Andersen's statement to Enron's shareholders and Board of Directors  
(from Enron's Annual Report)****Reports of Independent Public Accountants**

To the Shareholders and Board of Directors of  
Enron Corp.:

We have examined management's assertion that the system of internal control of Enron Corp. (an Oregon corporation) and subsidiaries as of December 31, 1999, 1998 and 1997 was adequate to provide reasonable assurance as to the reliability of financial statements and the protection of assets from unauthorized acquisition, use or disposition included in the accompanying report on Management's Responsibility for Financial Reporting. Management is responsible for maintaining effective control over the reliability of financial statements and the protection of assets against unauthorized acquisition, use or disposition. Our responsibility is to express an opinion on management's assertion based on our examination.

Our examinations were made in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the system of internal control, testing and evaluating the design and operating effectiveness of the system of internal control and such other procedures as we considered necessary in the circumstances. We believe that our examinations provide a reasonable basis for our opinion.

Because of inherent limitations in any system of internal control, errors or fraud may occur and not be detected. Also, projections of any evaluation of the system of internal control to future periods are subject to the risk that the system of internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that the system of internal control of Enron Corp. and its subsidiaries as of December 31, 1999, 1998 and 1997 was adequate to provide reasonable assurance as to the reliability of financial statements and the protection of assets from unauthorized acquisition, use or disposition is fairly stated, in all material respects, based upon current standards of control criteria.

Arthur Andersen LLP

Houston, Texas  
March 13, 2000

To the Shareholders and Board of Directors of  
Enron Corp.:

We have audited the accompanying consolidated balance sheet of Enron Corp. (an Oregon Corporation) and subsidiaries as of December 31, 1999 and 1998 and the related consolidated statements of income, comprehensive income, cash flows and changes in shareholders' equity for each of the three years in the period ended December 31, 1999. These financial statements are the responsibility of Enron Corp.'s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Enron Corp. and subsidiaries as of December 31, 1999 and 1998, and the results of their operations, cash flows and changes in shareholders' equity for each of the three years in the period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 18 to the consolidated financial statements, Enron Corp. and subsidiaries changed its method of accounting for costs of start-up activities and its method of accounting for certain contracts involved in energy trading and risk management activities in the first quarter of 1999.

Arthur Andersen LLP

Houston, Texas  
March 13, 2000

## Exhibit 8

### Nancy Temple's E-Mail on Document Retention, 12<sup>th</sup> October 2001

To: David B. Duncan@ANDERSEN.COM WO  
CC:  
BCC:  
Date: 10/12/2001 08:56 AM  
From: Michael C. Odom  
Subject: Document retention policy  
Attachments:

---

More help.

----- Forwarded by Michael C. Odom on 10/12/2001 10:55 AM  
-----

To: Michael C. Odom@ANDERSEN.COM WO  
Cc:  
Date: 10/12/2001 10:53 AM  
From: Nancy A. Temple, Chicago 33 W. Monroe, 50/11234  
Subject: Document retention policy

Mike –

It might be useful to consider reminding the engagement team of our documentation and retention policy. It will be helpful to make sure that we have complied with the policy. Let me know if you have any questions.

Nancy

Source: HoustonChronicle.com

**Exhibit 9****Nancy Temple's Memo on Document Retention, 10<sup>th</sup> November 2001****FindLaw**

WWW.FINDLAW.COM

To: David B. Duncan; D. Stephen Goddard Jr; Thomas H. Bauer; Debra A. Cash;  
Roger D. Willard; Timothy K. McCann

CC: Caroline K. Cheng; Michelle A. Molay, Anne C. O'Loughlin

BCC:

Date: 11/10/2001 08:40AM

From: Nancy A Temple

Subject: Enron – Procedures for Responding to Subpoenas and Litigation

Attachments:

---

Please forward this message to the Enron engagement team which confirms the voicemail message that was forwarded to the team yesterday regarding instructions for responding to subpoenas and litigation relating to Enron. Thank you.

Nancy Temple.

**MEMORANDUM TO ALL U.S ENRON ENGAGEMENT PERSONNEL**

The press stories relating to Enron have led to an increasing number of lawsuits in recent days. Although the initial lawsuits that were filed did not name Andersen as a defendant, we have learned of one new lawsuit that does name Andersen and there have been reports of a second suit. The SEC has recently opened a formal investigation relating to Enron and as mentioned in the voicemail previously sent to you on Thursday afternoon, we received our first communication from the SEC in the form of a subpoena for the production of documents. We have also received a second subpoena in a lawsuit in which Andersen is not a defendant.

One of the first things we must do in preparing to respond to these subpoenas and lawsuits is to take all necessary steps to preserve all of the documents and other materials that we may have relating to the claims that are being filed. To do this, we must first ensure that all documents and materials

already in existence are preserved and that nothing is done to destroy or discard any of the information and materials now in your possession. The second step is to ensure that going forward any documents or other materials that are created as part of Andersen's continuing work relating to Enron and that also related to the claims being filed in the lawsuits are also preserved. This second step may go beyond what the law requires us to do under these circumstances, but we want to take this step so that no one in the future can falsely accuse Andersen of trying to hide any information relating to these matters and so that the lawyers representing Andersen in these matters will have all of the information necessary to represent us.

We are in the process of setting up a system to collect all of the documents and materials relating to the litigation and for copying and storage in one central location. We hope to create a system that causes all of you as little inconvenience as possible and that will not interfere unduly with your ongoing work on Enron-related matters. In advance of our physically collecting these materials, however, it is important that you take steps to preserve all of them. We are therefore instructing that you take the following immediate steps relating to documents and other materials relating to Enron engagements:

1. Existing Documents. Effective immediately, all existing Enron-related documents and materials must be preserved and nothing should be destroyed or discarded. This includes all copies and all originals of work papers, all drafts, and all informal files, desk files, e-mails, Lotus Notes, handwritten notes, faxes, memos, forms, calendar entries, lists and so forth, whether in electronic or hard copy and whether on the Firm's shared drive or on the hard drive of your firm-issued computer or any location where you commonly store business information, including your home computer and any hand held computing device. You should not, for example, delete from your computer any e-mails relating to Enron, or any computer work files relating to Enron, or any documents relating to Enron, even if those documents are only in draft or preliminary form. The best thing to do is simply to preserve everything in the form that it now exists.

2. Continuing Work. With respect to work in progress and new documents and materials that are created in the course of ongoing work in the future, you are not required to preserve materials on new Enron work that is not related to legal claims about Enron's prior financials and public statements. You should however take steps to preserve any new materials that are generated related to prior financial or public statements issues. This would

include, for example, new materials that may relate to any restatements of prior transactions, as well as any off-balance sheet transactions involving Enron. The simplest way to do this going forward is to create a box in your office and a separate file on a computer where you can collect new materials in these categories that might not otherwise be kept, such as drafts, notes, e-mails, superseded memos, etc. We will provide a label for your box and will periodically collect materials from these boxes as our work continues.

We understand that the document preservation steps described above are a burden, but it is important that we do everything we can in these areas for the reasons explained above, and the lawyers handling these matters are available to answer any questions you may have to help streamline the process.

Finally, it is very important that you not discuss Enron and the lawsuits with anyone, whether inside or outside of the Firm. This specifically includes any individuals at the client and former employees of Andersen. If anyone attempts to discuss any lawsuit-related matters with you, please ask the individual to call Caroline Cheng, an attorney in our legal group. Nancy Temple will be the attorney primarily responsible for Enron-related litigation. Caroline Cheng and paralegals Michelle Molay and Anne O'Loughlin will be assisting her. If you have any further questions, please contact one of them.

Thank you for your cooperation.

## **Exhibit 10** **Andersen's Fall From Grace\***

### **22 October 2001**

The SEC announces an investigation into collapsed energy giant Enron, one of Andersen's biggest clients. Andersen partners on the Enron engagement team order wholesale destruction of Enron-related documents.

### **8 November 2001**

Enron is forced to revise its financial statements for the past five years, statements that Andersen had previously approved, to account for \$586 million in losses. Andersen officially notified of the SEC investigation and orders preservation of all Enron-related documents.

### **2 December 2001**

Enron files for Chapter 11 bankruptcy, the largest corporate failure in U.S. history.

### **13 December 2001**

Andersen executives tell U.S. Congress that they had warned Enron about "possible illegal acts" after Enron withheld crucial data about its finances from Andersen.

### **9 January 2002**

The U.S. Justice Dept announces it has opened a criminal investigation into Andersen.

### **10 January 2002**

Andersen admits that its partners and staff shredded thousands of Enron-related documents.

### **15 January 2002**

Andersen fires David Duncan, the partner in charge of Enron's audits.

### **17 January 2002**

Enron fires Andersen, blaming the firm for destroying documents needed by government investigators.

### **4 February 2002**

Former Federal Reserve chairman Paul Volcker hired to introduce reforms at Andersen in an effort to restore its reputation.

**14 March 2002**

The U.S. Justice Department charges Andersen with obstruction of justice, for deliberately destroying evidence relating to its audit of Enron whilst an investigation was underway.

**8 April 2002**

7,000 employees laid off, around 25% of the firm's U.S. workforce.

**7 May 2002**

The trial begins, after settlement talks between Andersen and the Justice Dept break down.

**12 June 2002**

The jury is deadlocked. The judge grants permission to deliver a guilty verdict against Andersen even if jury members fail to agree which individual was responsible for the alleged actions.

**15 June 2002**

Andersen (U.S. arm) is found guilty of obstruction of justice. The firm agrees to cease auditing public companies by 31 August.

\* Source: BBC News '*Andersen's Fall From Grace*', 17 June 2002, at <http://news.bbc.co.uk>.

**Exhibit 11**  
**Memo from Andersen's Carl Bass on Enron Account**

**ARTHUR ANDERSEN**

**PROFESSIONAL STANDARDS GROUP**

To: John E. Stewart@ANDERSEN WO  
Date: 03/04/2001 06:46 PM  
From: Carl E. Bass, Houston, 237 / 2314  
Subject: Enron

I know you did not ask for this but I believe you should be at least have a version of what I know about this Enron “thing” from me. You may share this with anyone you deem appropriate – we are after all partners in this Firm and should be able to have an open dialogue about issues, especially those that affect partners. In addition, it appears that I have been the subject of some conversation and no one has discussed this with me directly. So treat this as my own New York Times OpEd piece, except we are not discussing Presidential pardons.

**The Enron “thing” with me**

With regard to this “thing”, I believe that several points need to be made. There appears to be some sort of assertion that I have a “problem” with Rick Causey or someone at Enron that results in me having some caustic and inappropriate slant in dealing with their questions. You may recall that when I joined the PSG on December 1, 1999, Dave Duncan had requested 500-750 hours of my time on Enron specific consultation. At the time, I/we was/were told that this was cleared with the client. If in fact I had some sort of “problem”, one would have thought that would have surfaced at that time. The client would have vetoed such an arrangement. In fact, I was told this was sold to them. Logic would also seem to dictate that if there was some sort of “problem” I would have been removed as one of the engagement partners, much less been placed on it to begin with. Believe me, if I had some “problem” I would have never requested to have been put on the engagement given the complexity and challenges that that engagement entails. So any notion that there is some sort of long, deep seeded animosity needs to be dispelled as it simply is not true – nor do the facts warrant it. I should also note that I have gone to great lengths to get Causey in front of standard setters. For example, I was able to get Causey to be a guest at the EITF meeting when tolling agreements were discussed because they had a vested

interest in the accounting for those transactions. If I had some sort of axe to grind, I would not have even orchestrated that.

With regard to the yearend issues that apparently triggered this “thing with me”, let’s go through them one by one. Again, there was dialogue on process here that I was not party to but apparently I have some sort of “problem” here.

1. Blockbuster transaction – Roger Willard and Clint Carlin approached me for about 15 minutes one afternoon to discuss two things. One, whether an interest in joint venture could be securitized and two, what are the requirements to be a joint venture. With respect to the first question, I said yes as long as it is accounted for on the equity method. We then discussed the requirements of a joint venture, including the fact that it had to be a business. The original Blockbuster transaction was simply where Enron was going to contribute this contract and the other party was going to contribute systems and expertise to deliver this product to households. I received one other question from Clint Carlin, dealing with some puts and calls. About two months later Roger Willard asked whether the equity needed to be 3% of fair value or book value. At that time I was told that they were going to have some \$50 million gain on the sale of this venture interest immediately after the contract was signed and the venture was entered into. Furthermore, the other venture partner was not contributing anything. At that time, both you and I had expressed some concern about this deal. It should be noted that despite all of the turmoil over this, we (PSG) did not object to this transaction as it appeared to meet the technical requirements of Statement 125. We relied on the engagement team to address both the definition of a business and the valuation issues of immediate gain. The client’s proposed accounting nonetheless was sustained. At that time, I was aware of another securitization in which the client had provided a side agreement to guarantee the 3% residual equity at risk with the same counterparty in this transaction. Although it is not my job (which I acknowledged to the engagement team), I did suggest confirmation as an audit procedure. I believe knowledge of this did prompt us over a weekend to have the engagement team involve various levels of practice directors in this decision. In effect, this was a very risky transaction and we did not believe that the PSG should solely be in on this without others.

With respect to the infamous 4:1 test, they did not follow our advice on this. I did acknowledge several times with the engagement team that although our test is grounded in GAAP, we did make it up and it is no where to be found in

the accounting literature.

2. Networks transaction- Tom Bauer involved me on this transaction. It was similar to the one above but did involve the sale of an existing Enron business through a securitization transaction. This was probably the nth step of a series of permutations of this transaction that I had been involved since November. The only late issue on this came after the deal had been signed. This was one of those deals where Enron contributed a business worth \$100. A bank contributed cash totalling \$100. The bank did this through an SPE whereby the residential equity holder contributed \$3 and the debt holder contributed \$97. I was asked after the deal had been signed whether that was OK. We discussed this issue a lot within the PSG and had in fact had a client issue with the SEC along these lines. In addition, we had discussed this issue with the Enron engagement team last summer in which they documented the conclusion that the equity person would have had to contribute \$6. I understand now that the gain on that transaction was \$100 million. In addition, other Enron transactions had been capitalized as we have suggested.

The engagement team went back and had the equity holder contribute additional equity. The equity holder in this case was the LJM entity, a related party because the CFO is the managing equity member.

3. “Raptor” derivative transactions – Enron has entered into a series of complicated derivatives with a related party (the CFO) in which this related party CFO writes options to Enron to protect Enron’s investments in various internet businesses. The capital for the SPE is derived from Enron cash settled derivatives that are European in that they cash settle at the end of the derivative life. I will honestly admit that I have a jaded view of these transactions and “dragged my feet” initially. This was in part due to an impairment test that Deb Cash had devised to keep these transactions honest. The yearend issues dealt with the impairment test. The engagement team had asked whether these various SPEs could be cross collateralized so that losses in one entity could offset losses in another. I told them that as long as they were truly cross collateralized that seemed OK. The problem I was told was that the CFO had no reason to inject a loss on one vehicle. The client’s proposal was that the vehicles be cross collateralized but if there was a loss in one vehicle, the CFO had the option to remove the cross collateralization any time he chose to. Based on how the impairment test was devised, I did not see any way that this worked. In effect, it was heads I win, tails you lose. The

engagement team appeared to be split on this – two partners had a problem with the client’s proposed accounting and one did not. In the end, however, the engagement team agreed with me as did the Practice Director. It was decided by them to “fix” this feature before the release of the financial statements. One thing to note was I was told that the client never agreed to the impairment test to begin with. So the real issue that I thought had been addressed and resolved had never been resolved with the client.

One problem I had with Raptor was that the original structure was one in which the PSG was not consulted on. In that transaction, the SPE had at risk only a nominal amount of equity (less than the 3% residual at risk of the notional value of an internet investment). Furthermore the SPE was in a bankrupt entity so any loss on the derivative could not be funded by the SPE. I understood that there was a \$100 million loss on an internet investment that otherwise should have been reported absent the derivative. At no time was PSG consulted on the original structure – we did attempt to make sure the subsequent structures were adequately capitalized.

Those are the yearend issues. In total they represent about \$150 million plus of income or avoided losses at yearend – and all involved the Practice Director. At no time did I ever have communication with the client on these issues. All of my communications were solely with the engagement team. You can understand then as to how I am perplexed as to how the client even knows I was consulted on with respect to these issues and how they believe I am too caustic and cynical with respect to their transactions (see below).

The only other issue that came up post yearend but affected 2000 was the Azurix impairment. I was consulted on an impairment issue at the Azurix level. I told the engagement team that their facts were a little shaky but if they could prove them then they had a position. It was not, however, without risk. At the time, Azurix was going through a “going private” transaction. The client wanted to record an impairment in the fourth quarter. I was also consulted on the impairment issue at the Enron level of its investment in Azurix. You had told them about 6-9 months ago that 6-9 months was a good indicator of whether an impairment was permanent with respect to that investment. I had repeated that advice post yearend but by then the investment was under water for about 18 months. I told the engagement partner that it was judgment – not really PSG’s call. I was told by him that “he had never communicated the original advice to the client and therefore he could not go in and do so now.” I

was led to believe that he went to his Practice Director. Again, not really our call.

## **Process**

Apparently, part of the process issue stems from the client knowing all that goes on within our walls on our discussions with respect to their issues. I believe that when we are either having discussions or have reached a decision, the FIRM has done so. The PSG only gives advice. The engagement partners and practice directors then reach a decision based on that advice as well as other considerations, but it is the FIRM that does so. 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 learned that lesson the hard way when I was senior working for Gary Goolsby about 17 years ago. 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 been on calls where the EA has interrupted the call saying that so and so was waiting for an answer from me on this that or the other. In fact, the client called during a meeting on the Raptor derivative transactions between me, the Practice Director, and the engagement team. One of the partners told the EA that interrupted us that “they were still meeting with Carl”.

I have also noted a 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. But lately managers have been posing their questions that way.

Let me propose an alternative. The engagement team should prepare a memo documenting all aspects of the transaction as well as the research that supports a conclusion or the conflicting research that leads to grayness. All too often (in fact, without exception), it has lately been a call from a manager with a flowchart and we then have to slug through it to find the real issues. For example, within the past week the client proposed placing a contract into a “joint venture”. An interest in the joint venture would then be sold for a \$20-40 million gain. The parties to the joint venture were the same parties to the contract. There were no customers (the customer was the other “venturer”), no process, no business. In fact the press release was clear that a contract had

been entered into. There is no mention of a joint venture. In effect, nothing was accomplished in this transaction except a sale of future revenues. The engagement partner agreed with my view and in fact had the same view. She was seeking concurrence. I was told they booked the transaction any way and that we will propose a PAJE.

Once we conclude on something, or render some advice, the engagement team should deliver that advice or conclusion as if it was their own. It is after all the engagement team's responsibility to sign the opinion – not ours.