2004

Enron and Andersen - What Went Wrong and Why Similar Audit Failures Could Happen Again

Matthew J. Barrett

Enron and Andersen—What Went Wrong and Why Similar Audit Failures Could Happen Again

*Matthew J. Barrett**

Years may pass before the public finds out exactly why Andersen's audits of Enron failed to uncover the pervasive accounting fraud at the company, but several factors likely contributed to the audit failure. Unconscious bias, compounded by organizational flaws and a culture at Andersen that emphasized marketing non-audit services to audit clients in an effort to boost profits; significant conflicts of interest and self-interest; and greed all help explain why Andersen did not (1) catch the problems at Enron, and (2) tell the world that such problems existed. Although Congress attempted to address some of the perceived problems in the Sarbanes-Oxley Act of 2002 ("SOx"), several significant gaps remain because the reforms do not adequately address unconscious bias.

Aren't audits supposed to be sign-offs on the appropriateness of a company's financial statements? Not exactly. Before we examine what went wrong in Andersen's audits, we should clarify what an audit hopes to accomplish. In an audit, the auditor evaluates the various representations that an enterprise's management asserts in the financial statements and related notes about the firm's assets and liabilities at a specific date and transactions during a particular accounting period so that the auditor can render a report on (and almost always express an opinion about) those financial statements and accompanying disclosures. Ultimately, the auditor seeks to express an opinion as to whether the financial statements present fairly, in all material respects, the enterprise's financial condition, results of operations, and cash flows in conformity with generally accepted accounting principles. If the examination of the entity's procedures and accounting records allows the auditor to reach an affirmative conclusion, then the auditor will issue an unqualified or "clean" opinion. Even an unqualified opinion, however,

---

*Professor of Law, Notre Dame Law School. The author gratefully acknowledges valuable research assistance from John J. Barber, a member of the class of 2005 and an Arthur Andersen alum, and helpful comments and suggestions from David R. Herwitz.

does not guarantee the accuracy of financial statements; such an opinion provides only "reasonable assurance" that the financial statements fairly present, in all material respects, the enterprise's financial condition, results of operations, and cash flows in conformity with generally accepted accounting principles.[1]

Differing perceptions exist between the assurance that investors and other users of financial statements expect and that which auditors provide.[2] An important study during the early 1990s revealed that almost half of the investors surveyed believed that audited financial statements provide absolute assurance against errors or unintentional misstatements. In that same survey, more than seventy percent expressed a belief that audited financial statements provide absolute assurance against fraud or intentional misstatements. Unfortunately, even in a properly planned and executed audit, fraud can more easily avoid detection than unintentional errors. As a result, investors set a higher standard for auditors to uncover fraud than to discover errors and their expectations exceed the assurance actually provided. The accounting profession has labeled these misconceptions as the "expectation gap."[3]

To reiterate, an audit provides only *reasonable assurance* against material misstatements, whether intentional or unintentional, in the financial statements. In reality, an audit does not guarantee that error or fraud has not affected the financial statements. Similarly, even an unqualified report does not offer any assurance that the enterprise presents a safe investment opportunity or will not fail. At the same time, however, then-existing generally accepted auditing standards required an auditor to assess the risk that errors and fraud may cause the financial statements to contain a material misstatement. In addition, the auditor faced a professional obligation to design the audit to provide reasonable assurance that the examination would detect material errors and misstatements, to exercise professional skepticism, and to perform and evaluate audit procedures to attain the required assurance.[4]

Didn't a jury convict Andersen for fraud in its audits of Enron? No. Although David Duncan, Andersen's former lead audit partner on the Enron account, pleaded guilty to

[1] *See generally* DAVID R. HERWITZ & MATTHEW J. BARRETT, MATERIALS ON ACCOUNTING FOR LAWYERS 180–82, 200–04, 215–17, 233–40 (3d ed. 2001).

[2] *Id.* at 227–33.

[3] Marc J. Epstein & Marshall A. Geiger, *Investor Views of Audit Assurance: Recent Evidence of the Expectation Gap*, J. ACCT., Jan. 1994, at 60.

[4] *See* CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, Statement on Auditing Standards No. 82 (American Inst. of Certified Pub. Accountants 1997) ("SAS No. 82"); *see also* HERWITZ & BARRETT, *supra* note 1, at 231–33. Effective for audits of financial statements for periods beginning on or after Dec. 15, 2002, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, supersedes SAS No. 82. CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, Statement on Auditing Standards No. 99 (American Inst. of Certified Pub. Accountants 2002). In addition to previous expectations, SAS No. 99 now requires an auditor to extend the exercise of professional skepticism to the possibility that fraud may cause a material misstatement. In particular, auditors must evaluate specific fraud risks and document the plan and procedures used to evaluate those risks. *Id.*

obstruction of justice during the SEC's inquiry into Enron's collapse and a federal jury convicted Andersen on one felony count of obstructing justice, those crimes did not relate to the audits themselves.[5]

As to those audits, however, Andersen has acknowledged that its audits failed to require Enron to include two special purpose entities ("SPEs") in the company's consolidated financial statements as generally accepted accounting principles required.[6] Shortly before its bankruptcy filing, Enron restated its financial statements back to 1997 to include those two SPEs.[7] During his Congressional testimony in December 2001, then-Andersen Chief Executive Officer Joseph F. Berardino blamed Enron for withholding "critical information" about the larger SPE, an entity called Chewco. He candidly admitted that Andersen attributed the incorrect accounting on the smaller SPE, a subsidiary of the entity known as LJM1, to "an error in judgment."[8] At that time, financial accounting rules required that, among other things, unrelated parties own an investment equal to at least three percent of the fair value of an SPE's assets to avoid consolidation.[9] (Accounting rule-makers subsequently adjusted that threshold upwards to ten percent,[10] and they continue to study the consolidation requirements.[11] Those rule-makers also now refer to SPEs as "variable interest entities," or VIEs.)[12] In 1999, after reaching some conclusions on valuation issues involving various assets and liabilities, Andersen's audit team originally determined that unrelated parties held more than three percent of the subsidiary's residual equity, thereby meeting the required

[5] Flynn McRoberts et al., *A Final Accounting: Repeat offender gets stiff justice*, CHI. TRIB., Sept. 4, 2002, at 1, *available at* 2002 WL 26771271. For a discussion of the Andersen criminal case, see Amon Burton & John S. Dzienkowski, *this book at* 689–762.

[6] *Before the House Committee on Financial Services*, 107th Cong. (Dec. 12, 2001) (statement of Joseph F. Berardino, Managing Partner–Chief Executive Officer, Andersen), *available at* http://news.findlaw.com/hdocs/docs/enron/andersen121201tst.pdf [hereinafter Berardino testimony].

[7] *See* ENRON CORP., FORM 8-K, CURRENT REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (filed Nov. 8, 2001) (disclosing required restatement of previously issued financial statements), *available at* http://www.sec.gov/Archives/edgar/data/1024401/000095012901503835/h91831e8-k.txt; *see also* Jonathan Weil, *Enron's Auditors Debated Partnership Losses, Andersen Memos Show That the Accountants Knew of Raptor Status*, WALL ST. J., Apr. 3, 2002, at C1, *available at* 2002 WL-WSJ 3390542.

[8] Berardino testimony, *supra* note 6.

[9] William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1306, n. 118 (2002) (explaining the origin and history of the three percent test); *see also* Gordon Housworth, *Enron & Arthur Anders[e]n: to comply is not enough*, CRITICALEYE, Aug. 2002, at 21–25, *available at* http://www.emeaconsulting.com/Critical_Eye/Critical_EYE_aug_2002.pdf.

[10] CONSOLIDATION OF VARIABLE INTEREST ENTITIES, FASB Interpretation No. 46, ¶¶ 9, C21–25 (Financial Accounting Standards Bd. 2003), *available at* http://www.fasb.org/interp46.pdf.

[11] FINANCIAL ACCOUNTING STANDARDS BOARD, *Project Updates: Consolidations Policy and Procedures* (Apr. 8, 2003), *available at* http://www.fasb.org/project/consol.shtml (last visited June 13, 2003).

[12] CONSOLIDATION OF VARIABLE INTEREST ENTITIES, *supra* note 10, at ¶ 6.

threshold for non-consolidation. In reviewing the transaction in October 2001, Andersen determined that the audit team reached its initial judgment in error and advised Enron to correct the error.[13]

Based upon testimony at Andersen's criminal trial, internal documents that Congressional investigators obtained, and a report by a special committee on Enron's board, an article in *The Wall Street Journal* immediately after Andersen's conviction highlighted inadequate disclosures, questionable transactions with other SPEs, the premature recognition of revenue, and the failure to insist that Enron record adjustments recommended in previous audits as other potential deficiencies in Andersen's audits.[14] Governmental investigations of Andersen's audits presumably continue, and civil litigation remains pending.[15]

So why did Andersen fail to catch the problems at Enron? Although numerous conflicts of interests permeated the relationship between Andersen and Enron, unconscious bias—the propensity to interpret data in accordance with our desires—best explains why Andersen's audits failed. Other explanations include the culture and organizational flaws at Andersen.

Unconscious bias. A recent *Harvard Business Review* article entitled "Why Good Accountants Do Bad Audits" argues that unconsciously biased judgments, rather than criminal collusion between auditors and management, often cause audit failures.[16] Two recent experiments, one with business students and the other with professional auditors, demonstrated that even the suggestion of a hypothetical relationship with a client distorts an auditor's judgments. Long-standing relationships involving millions of dollars in ongoing revenues can only magnify the results. The article posits that three structural aspects of the accounting industry—ambiguity, attachment, and approval—create significant opportunities for bias to influence auditing judgments. In addition, the article highlights three aspects of human nature—familiarity, discounting, and escalation—that amplify auditors' unconscious biases.[17]

Ambiguity. Accounting remains an art, not a science, which requires enterprises, and their auditors, to exercise professional judgment in preparing and auditing financial statements. Although we often hear accountants referred to as "bean counters" and may believe that accounting provides clear-cut answers to all questions, financial accounting requires various estimates that affect the amounts shown in the financial state-

[13] Berardino testimony, *supra* note 6.

[14] Ken Brown, *Andersen Staff Works to Tie Up Loose Ends, Andersen Might Face More Legal Problems Beyond Guilty Verdict*, WALL ST. J., June 17, 2002, at C1, *available at* 2002 WL-WSJ 3397879.

[15] *Id.*

[16] Max H. Bazerman, George Loewenstein & Don A. Moore, *Why Good Accountants Do Bad Audits*, HARV. BUS. REV., Nov. 2002, at 96.

[17] *Id.*

ments, including the reported amounts of assets, liabilities, revenues, and expenses. In addition, generally accepted accounting principles often allow alternative treatments for the same transaction or events and may not address a particular situation because business transactions evolve more rapidly than accounting principles. Witness the Internet's recent emergence and Enron's transformation from a regional natural gas company to a global energy and commodities trader.[18] Given the various accounting estimates and permissible choices in accounting methods, a typical business enterprise could potentially select from more than a million possible "bottom lines."[19] To illustrate, the fast-food chain Wendy's once advertised that its customers could order a hamburger 256 different ways. Wendy's offered eight different toppings and condiments, such as lettuce, tomato, cheese, ketchup, and mustard, which customers could request. Either selecting or omitting those individual extras translated to 256 options, a number that grew exponentially with each extra. For public companies today, generally accepted accounting principles allow even more choices. In this regard, entities must decide when to recognize revenue; estimate sales returns and allowances, warranty costs, useful lives, and salvage values; select inventory and depreciation methods; and decide whether or not to expense stock options. Bias thrives in such an environment.[20]

Attachment. The auditor's business interests in fostering a long-term relationship with a client's management encourage auditors to render "clean" audit opinions in an effort to retain any existing engagements and to secure future business. Auditors that issue anything but an unqualified opinion frequently get replaced.[21] During the late 1990s, the largest public accounting firms—first the Big Six and then the Big Five (now the Final Four)—increasingly provided non-audit services, such as consulting, internal auditing, and tax advising, often to the very enterprises they audited.[22] During 2000, Enron paid $52 million to Andersen—$25 million for auditing services, and an additional $27 million for non-auditing services, including $3.5 million for tax work—and ranked as Andersen's second-largest client.[23] Perhaps more significantly, an internal Andersen memo in February 2001 regarding the retention of Enron as an audit client refers to $100 million a year in potential revenues from Enron.[24] Even if

---

[18] *See generally* Matthew J. Barrett, *Enron, Accounting, and Lawyers*, NOTRE DAME LAWYER, Summer 2002, at 14, 15, *available at* http://www.nd.edu/~ndlaw/alumni/ndlawyer/barrett.pdf.

[19] HERWITZ & BARRETT, *supra* note 1, at 173 (citing R.J. Chambers, *Financial Information and the Securities Market*, 1 ABACUS 3, 13–16 (1965), *reprinted in* R.J. CHAMBERS, ACCOUNTING FINANCE AND MANAGEMENT, 185–88 (1965)).

[20] Bazerman, Lowenstein & Moore, *supra* note 16, at 98–99.

[21] *Id.* at 99.

[22] ENRON CORP., SCHEDULE 14A, PROXY STATEMENT PURSUANT TO SECTION 14(a) OF THE SECURITIES EXCHANGE ACT OF 1934 (filed Mar. 27, 2001), *available at* http://www.sec.gov/Archives/edgar/data/1024401/000095012901001669/0000950129-01-001669.txt; *see also* Barrett, *supra* note 18, at 16.

[23] Berardino testimony, *supra* note 6 (detailing non-audit fees that Enron paid to Andersen in 2001).

[24] Tom Hamburger & Ken Brown, *Andersen Knew of Enron Woes a Year Ago*, WALL ST. J., Jan. 17, 2002, at A3, *available at* 2002 WL-WSJ 3383224.

Andersen could absorb the loss of Enron as a client, individual careers and the Houston office depended upon retaining the Enron engagement. As the audit partner for the firm's second-largest client, David B. Duncan enjoyed clout not only in the Houston office, but throughout Andersen.[25]

Like the remaining Final Four accounting firms, Andersen encouraged its employees, especially those not likely to become partners, to take jobs with clients or potential clients when they left the firm. The resulting "revolving door" between Andersen and Enron only enhanced the financial attachment. From 1989–2001, eighty-six people left Andersen to work for Enron.[26] Andersen alumni at Enron included Richard A. Causey, its chief accounting officer and a former Andersen audit manager; Jeff McMahon, Enron's treasurer; and Sherron Smith Watkins, the vice president who unsuccessfully tried to blow the whistle on Enron's aggressive accounting.[27] Employees at Enron often referred to Andersen as "Enron Prep."[28] In the "up or out" environment at Andersen, everyone who worked on the Enron account had subtle incentives to keep both their bosses and the people at Enron happy.

The so-called "integrated audit" that Andersen employed at Enron and then sought to market more widely to other clients also documents attachment. Under this model, Andersen sought to combine its role as external auditor with internal auditing, the process whereby an enterprise checks its own books.[29] Paralleling and sometimes overlapping outside or independent audits, internal audits seek to ensure that an enterprise follows its procedures, safeguards its assets, and operates efficiently.[30] Under a five-year, $18 million contract that sought to create an "integrated audit," Andersen took over Enron's internal auditing in 1994, transforming dozens of Enron staffers into Andersen employees.[31] *The Wall Street Journal* reported that before Enron's collapse,

[25] Flynn McRoberts et al., *A Final Accounting: Ties to Enron blinded Andersen*, CHI. TRIB., Sept. 3, 2002, at 1, *available at* 2002 WL 26770980.

[26] Peter Behr & April Witt, *Concerns Grow Amid Conflicts*, WASH. POST, July 30, 2002, at A1, *available at* 2002 WL 24824440.

[27] ENRON AND BEYOND: TECHNICAL ANALYSIS OF ACCOUNTING, CORPORATE GOVERNANCE, AND SECURITIES ISSUES 156 (Julia K. Brazelton & Janice L. Ammons, eds., 2002) [hereinafter ENRON AND BEYOND]; *see also* John R. Wilke, Anita Raghavan & Alexei Barrionuevo, *U.S. Will Argue Andersen Knew of Missteps, Prosecutors Marshal Evidence About Role in Flawed Enron Work*, WALL. ST. J., May 7, 2002, at C1, *available at* 2002 WL–WSJ 3393942; *see also* Alexei Barrionuevo & Jonathan Weil, *Duncan Knew Enron Papers Would be Lost*, WALL. ST. J., May 14, 2002, at C1, *available at* 2002 WL-WSJ 3394733.

[28] Behr & Witt, *supra* note 26.

[29] Alexei Barrionuevo & Jonathan Weil, *Partner Warned Arthur Andersen On Enron Audit*, WALL ST. J., May 9, 2002, at C1, *available at* 2002 WL–WSJ 3394352; *see also* Barrionuevo &Weil, *supra* note 26 ("Andersen held out Enron as the prime example of its 'integrated' audit approach. . . .").

[30] HERWITZ & BARRETT, *supra* note 1, at 202–04.

[31] McRoberts et al., *supra* note 25; Alexei Barrionuevo, *Questioning the Books: Court Documents Show Andersen's Ties With Enron Were Growing in Early '90s*, WALL ST. J., Feb. 26, 2002, at A6, *available at* 2002 WL-WSJ 3386987.

more than 100 Andersen employees worked in leased space inside Enron's headquarters in Houston.[32] In videotapes that Andersen filmed to market the "integrated audit," people at both Andersen and Enron described how intertwined their operations had become. In one segment, Jeffrey Skilling, then Enron's president, commented: "I think over time we and Arthur Andersen will probably mesh our systems and processes even more so that they are more seamless between the two organizations."[33] Coupled with the inherent ambiguity in financial statements, such attachment can influence auditors to accept the "client's" interpretation and application of generally accepted accounting principles.[34]

Approval. Management has historically selected the accounting principles and estimates that an enterprise uses to prepare its financial statements.[35] An audit essentially endorses or rejects the accounting choices that the client's management has made.[36] Research has shown that self-serving biases become even stronger when people are endorsing someone else's judgments, provided those judgments align with their own biases, than when they are asked to make original judgments themselves. This research suggests that unconscious bias can cause auditors to accept more aggressive accounting treatments than the auditor might propose independently.[37]

Familiarity. People are less willing to harm individuals that they know relative to strangers. People are even less willing to harm paying clients, or individuals they consider paying clients, with whom they enjoy ongoing relationships.[38] Like lawyers for corporations, who represent the entity and not the officer who hired them, auditors' real responsibilities flow to the investing public, not the manager or individual who retained them.[39] An auditor who suspects errors or misstatements, whether intentional or not, must choose, perhaps unconsciously, between harming a known individual, and likely the auditor's own self-interest, by questioning the accounting, or injuring faceless others by failing to object to the possibly incorrect numbers. Such biases only grow stronger as personal relationships with the client's management, sometimes former auditing colleagues, deepen.[40] David Duncan and Rick Causey often vacationed together, annually leading a group of Andersen and Enron "co-workers" on golfing trips to elite courses around the county.[41] The "revolving door" between Andersen and Enron

---

[32] Ianthe Jeanne Dugan, Dennis Berman & Alexei Barrionuevo, *On Camera, People at Andersen, Enron Tell How Close They Were*, WALL ST. J., Apr. 15, 2002, at C1, *available at* 2002 WL-WSJ 3391766.

[33] *Id.*

[34] Bazerman, Lowenstein & Moore, *supra* note 16, at 99–100.

[35] HERWITZ & BARRETT, *supra* note 1, at 173.

[36] Bazerman, Lowenstein & Moore, *supra* note 16, at 99–100.

[37] *Id.* at 100–01.

[38] *Id.* at 100.

[39] HERWITZ & BARRETT, *supra* note 1, at 182–83.

[40] Bazerman, Lowenstein & Moore, *supra* note 16, at 100.

[41] McRoberts et al., *supra* note 25.

and the "integrated audit" model also strengthened the familiarity.[42] As a result of familiarity, auditors likely will believe assertions of managers with whom they have worked in the past because a relationship of familiarity and trust erodes the auditor's objectivity and neutrality.[43]

Discounting. Immediate consequences influence behavior more than delayed ones, especially when uncertainty accompanies the future costs. This tendency appeals to the propensity to place more emphasis on the short-term effect of decisions than their long-term ramifications. Immediate adverse consequences, including damage to the relationships with the client and its management, possible loss of the engagement, and potential unemployment, may dissuade auditors from issuing anything other than an unqualified opinion. By comparison, the costs arising from an audit failure, namely civil lawsuits, disciplinary proceedings, and reputational losses, appear distant and uncertain, or even unlikely.[44] After an earlier audit failure at Waste Management, for which Andersen agreed to the largest fine ever against an auditor, the firm did not fire the audit partners whom the SEC sanctioned.[45] Ironically, one of those auditors wrote the document retention policy featured in Andersen's criminal trial for obstructing justice in the Enron investigation.[46] The internal Andersen memo regarding the decision to retain Enron as a client documents Enron's aggressive accounting practices and potential conflicts of interest by then-Enron chief financial officer Andrew Fastow. Nevertheless, Andersen executives decided to retain Enron as a client because "we [have] the appropriate people and processes in place to serve Enron and manage our engagement risks."[47] As total audit and other fees from Enron grew to $52 million in 2000, Andersen willingly assumed increasing engagement risks for a client that the firm believed could potentially generate $100 million in revenues annually.[48]

Escalation. People often hide or explain away minor mistakes, often without realizing what they are doing. Unconscious biases may cause an auditor to accept small imperfections in a client's financial statements.[49] Over time, such misstatements can become material. At that point, correcting the situation may require admitting previous errors or biases, restating the financial statements, or even resigning. Rather than take those actions, the auditor may try to conceal the problem, thereby escalating unconscious bias into fraud.[50] For example, after Andersen approved the non-consoli-

---

[42] *See supra* notes 26–34 and accompanying text.

[43] Bazerman, Lowenstein & Moore, *supra* note 16, at 100.

[44] *Id.*

[45] Flynn McRoberts et al., *A Final Accounting: Civil war splits Andersen*, CHI. TRIB., Sept. 2, 2002, at 1, *available at* 2002 WL 26770609.

[46] *Id.*

[47] Hamburger & Brown, *supra* note 24.

[48] *See id.*

[49] Bazerman, Lowenstein & Moore, *supra* note 16, at 100.

[50] *Id.*

dated accounting for various SPEs, the auditors later adopted an interpretation that enabled Enron to avoid recognizing losses for declines in the value of underlying investments in certain entities known as the Raptors.[51] At Andersen's criminal trial, prosecutors also introduced evidence to show that the firm's prior audit failures at Waste Management and Sunbeam gave Andersen a motive to hide the problems at Enron.[52]

The culture and an ineffectual Professional Standards Group at Andersen. Shortly after its conviction, a four-part series in *The Chicago Tribune* traced Andersen's collapse from the position it held for decades—as the "gold standard" for auditing firms in the United States—to convicted felon.[53] After the 1989 decision to create separate business units and profit pools for Arthur Andersen and Andersen Consulting, Arthur Andersen aggressively marketed more lucrative consulting services to its audit clients, which enabled Andersen's top partners to triple their earnings during the 1990s. In retrospect, this pursuit of profits ultimately led to the firm's destruction.[54]

Although only symbolic of this change in culture, the firm abandoned its traditional trademarked icon, two mahogany doors, for an orange ball dubbed "the logosphere" and branded itself simply as "Andersen."[55] More importantly, the firm evaluated and compensated audit partners for their ability to cross-sell other services and adopted a program labeled "2X" that sought to generate two dollars in consulting revenues for every dollar in audit revenues.[56] In essence, auditing became a "loss leader" to very profitable consulting services.[57]

Perhaps even more significantly, unlike the other Big Five firms, Andersen marketed itself as a firm in which the audit partner could make the final call on difficult accounting and auditing questions without having to secure approval from the firm's team of experts that reviewed and reached conclusions on such questions that local offices encountered. Andersen called this team of experts the Professional Standards Group.[58] Relying upon accounting professionals at the SEC and elsewhere, *Business Week* reported that "unlike other firms, Andersen allow[ed] regional partners—the

---

[51] Weil, *supra* note 7.

[52] Barrionuevo & Weil, *supra* note 29.

[53] Flynn McRoberts et al., *A Final Accounting: The fall of Andersen*, CHI. TRIB., Sept. 1, 2002, at 1, *available at* 2002 WL 26770388 [hereinafter McRoberts et al., *The fall of Andersen*]; McRoberts et al., *supra* note 45; McRoberts et al., *supra* note 25; McRoberts et al., *supra* note 5.

[54] McRoberts et al., *The fall of Andersen*, *supra* note 53; *see also* McRoberts et al., *supra* note 45.

[55] Ken Brown & Ianthe Jeanne Dugan, *Sad Account: Andersen's Fall From Grace Is a Tale of Greed and Miscues*, WALL ST. J., June 7, 2002, at A1, *available at* 2002 WL-WSJ 3397111.

[56] ARTHUR ANDERSEN, U.S. 1999 ANNUAL REPORT, 17–19 (2000), *available at* http://www.nrri.ohio-state.edu/oss/admin/vendorprop/andersen/ander1999.pdf (last visited June 12, 2003).

[57] *See generally* John C. Coffee, Jr., *Understanding Enron: It's About the Gatekeepers, Stupid*, 14–16 (July 30, 2002), *available at* http://ssrn.com/abstract_id=325240; *this book at* 125–143.

[58] *Id.* at 16, 22.

front-line executives closest to the companies they audit—to overrule the experts," and Andersen's Enron audit team did so on at least four occasions, allowing Enron to hide debt and inflate reported earnings.[59] Equally troubling, Andersen honored Enron's request to remove Carl E. Bass, then a member of the Professional Standards Group from that team, because his accounting stances were too conservative.[60]

Significant conflicts of interest and self-interest. As previously mentioned, among the services that Andersen sold to Enron and other audit clients were internal auditing services.[61] In essence, Andersen's outside auditors were evaluating the firm's consulting services.[62]

Recall also that Enron paid Andersen $27 million for non-auditing services during 2000. When non-audit fees comprise a significant part of an auditor's income from the audit client, those fees might easily tempt an auditor to overlook an enterprise's "aggressive" accounting simply to retain the client's non-audit business. At a minimum, those fees paid to Andersen call the appearance of Andersen's independence into question.[63] To repeat, even if Andersen could absorb the loss of a client like Enron, individual careers and offices that depended upon keeping Enron as a client would certainly suffer.[64]

Finally, the "revolving door" between Andersen and Enron created additional incentives for auditors interested in employment at Enron to try to keep Enron's management happy.[65]

How does Sarbanes-Oxley address these problems? SOx Section 301 required the SEC to prescribe rules that direct the national securities exchanges and national securities associations, such as the New York Stock Exchange and The Nasdaq Stock Market, Inc., to prohibit the listing of any company that does not place in an audit committee—a committee of independent directors presumably better able to protect the company's interests—the responsibility for hiring, compensating, and firing the auditor.[66] In April 2003, the SEC issued rules that require each national securities exchange and national securities association to submit proposed amendments to their listing rules that comply with the SEC rules by July 15, 2003.[67] The rules set Decem-

[59] Mike McNamee, *Out of Control at Andersen*, BUS. WEEK, Apr. 8, 2002, at 32.

[60] *Id.*

[61] *See supra* notes 29–34 and accompanying text.

[62] McRoberts et al., *supra* note 45.

[63] Barrett, *supra* note 18, at 16.

[64] *See supra* notes 23–25 and accompanying text.

[65] *See supra* notes 26–28.

[66] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–77 (codified at 15 U.S.C.A. § 78j-1 (West. Supp. 2003)).

[67] Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. 18,788, 18,817 (Apr. 16, 2003).

ber 1, 2003 as the deadline to obtain final approval. Under the SEC's rules, most domestic companies must comply with the new listing rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004, or (2) October 31, 2004.[68] In the meantime, most publicly traded companies have given their audit committee the exclusive power to hire, compensate, and fire the firm's auditor.

SOx and new final SEC rules also strengthen statutory and administrative requirements regarding auditor independence. SOx Section 201 lists various services outside the scope of the practice of auditors, including bookkeeping services, financial information systems design and implementation, appraisal or valuation services, fairness opinions, internal audit outsourcing services, management or human resources functions, and legal services, as "prohibited activities."[69] Although auditors can no longer perform internal auditing and many other consulting services for their audit clients, the SEC's new final rules issued in January 2003 reiterate its long-standing position that an accounting firm can render certain tax services to audit clients without impairing the firm's independence.[70] SOx Section 202, however, requires the audit committee to preapprove all audit and most non-audit services.[71]

SOx Section 203 provides that most accounting firms may not provide audit services to a publicly traded company, usually referred to as an issuer, if the lead audit partner or the reviewing audit partner has performed audit services for the issuer in each of the issuer's previous five fiscal years.[72] Section 206 prevents an auditing firm from auditing an issuer that employs in certain high-level positions an individual who served on the audit team during the past year.[73] The SEC's new regulations, which (subject to various transitional rules) became effective May 6, 2003, specify that the receipt of compensation by an "audit partner" based upon procuring engagements with the audit client for services other than audit, review, and attest services destroys independence.[74] The SEC rules also require a one-year "cooling off" period prior to the commencement of audit procedures if certain members of an audit client's senior management have served as members of the firm's audit team.[75] Finally, the rules generally require the rotation of the lead and concurring partners on an audit team every five years.[76]

---

[68] *Id.* at 18,817.

[69] Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, § 201, 116 Stat. 745, 771–72 (codified at 15 U.S.C.A. §§ 78j-1 & 15 U.S.C.A. § 7231 (West. Supp. 2003)).

[70] Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6017 (Feb. 5, 2003) [hereinafter Auditor Independence].

[71] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201, 116 Stat. 745, 771–72 (codified at 15 U.S.C.A. §§ 78j-1 & 15 U.S.C.A. § 7231 (West. Supp. 2003)).

[72] *Id.* § 203, 116 Stat. at 773 (codified at 15 U.S.C.A. § 78j-1 (West. Supp. 2003)).

[73] *Id.* § 206, 116 Stat. at 774–75 (codified at 15 U.S.C.A. § 78j-1 (West. Supp. 2003)).

[74] Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6024–26, 6047 (Feb. 5, 2003) (codified at 17 C.F.R. § 210.2-01(c)(8) (2003)).

[75] *Id.* at 6007–10, 6044–45 (Feb. 5, 2003) (codified at 17 C.F.R. § 210.2-01(c)(2)(iii) (2003)).

[76] *Id.* at 6017–22, 6047 (codified at 17 C.F.R. § 210.2-01(c)(6) (2003)).

SOx also creates the Public Company Accounting Oversight Board ("PCAOB") to register, regulate, and inspect public accounting firms that audit publicly traded companies; to establish or adopt auditing, quality control, ethics, independence, and other standards; and to conduct investigations and disciplinary proceedings when appropriate to enforce compliance with the law and professional standards.[77] Section 102 requires auditing firms to register with the PCAOB and each application for registration must contain a statement of the firm's quality control policies for its accounting and auditing practices.[78] This requirement should lead to more effective internal review and consultation committees inside auditing firms.

Do any gaps remain? To the extent that conflicts of interest cause audit failures, SOx addresses the problems for publicly traded enterprises subject to the SEC's jurisdiction, with one significant exception. Even though management can no longer hire and fire the auditor and the audit committee must approve any non-audit services, under the guise of increasing auditor independence, management can still potentially recommend that the audit committee hire another accounting firm to provide tax or other non-prohibited consulting services. Thus, if the auditor does not approve, or at least acquiesce in, certain accounting treatments or disclosures preferred by the client's management, the audit firm may risk losing significant non-audit revenues.[79] Recall that Enron paid Andersen $3.5 million for tax services in 2000.[80]

SOx largely misses the mark, however, if unconscious bias explains most audit failures. As long as financial or other incentives tempt auditing firms and their executives and employees to try to retain an audit engagement, unconscious bias will remain present. Thus, unconscious bias suggests the need to require mandatory rotation of audit firms after fixed terms for preset fees to eliminate the threat that the client can fire or otherwise punish the auditor for failing to approve questionable accounting practices.[81] SOx Section 207 directs the Comptroller General to study and review the potential effects arising from a limit on the period of years in which an audit firm may serve as the auditor for a particular issuer and to submit a written report to certain Congressional committees within one year after SOx's enactment.[82] While mandatory rotation of audit firms will certainly increase auditing fees, given unconscious bias and the enormous losses and damage from Enron scandal and other recent audit failures,

[77] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101, 116 Stat. 745, 750–53 (codified at 15 U.S.C.A. § 7211 (West. Supp. 2003)).

[78] *Id.* at § 102, 116 Stat. 745, 753–755 (codified at 15 U.S.C.A. § 7212 (West. Supp. 2003)).

[79] *See generally* HERWITZ & BARRETT, *supra* note 1, at 173–74, 192–93.

[80] Berardino testimony, *supra* note 6.

[81] Bazerman, Lowenstein & Moore, *supra* note 16, at 102.

[82] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 207, 116 Stat. 745, 775 (codified at 15 U.S.C.A. § 7232 (West. Supp. 2003)).

can companies any longer afford not to pay increased fees for the benefit of their investors, employees, and communities?

One final caveat: SOx (and the federal securities laws generally) does not apply to closely held firms and not-for-profit organizations that may require audited financial statements to obtain bank loans or for other reasons.[83] Those enterprises and their auditors remain outside the SEC's reach.

NOTES AND QUESTIONS

1. Even if the then-existing consolidation requirements under generally accepted accounting principles did not require Enron to consolidate the two SPEs, some commentators have argued that unconsolidated financial statements could not "present fairly" Enron's financial condition, results of operations, or cash flows. In other words, some critics of Andersen's audit reports believe that financial statements must both (i) comply with generally accepted accounting principles and (ii) "present fairly" the financial condition and results of operations. *See, e.g.*, Steve Liesman, *SEC Accounting Cop's Warning: Playing By Rules May Not Ward Off Fraud Issues*, WALL ST. J., Feb. 12, 2002, at C1, *available at* 2002 WL-WSJ 3385675; *see generally* DAVID R. HERWITZ & MATTHEW J. BARRETT, MATERIALS ON ACCOUNTING FOR LAWYERS 230 (3d ed. 2001). In *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), the Second Circuit upheld criminal convictions against three auditors of Continental Vending Machine Corporation after they challenged a jury instruction that described the "critical test" as whether the financial statements as a whole "fairly presented" the corporation's financial position and accurately reported its operations. *Id.* at 805–06. Various accounting experts testified that the financial statements did not violate generally accepted accounting principles. The Second Circuit declined to overturn the trial court's refusal to give a requested instruction that essentially would have given the defendants a complete defense to the criminal charges if the financial statements conformed to generally accepted accounting principles. In other words, the Second Circuit ruled that compliance with generally accepted accounting principles does not automatically shield an auditor from criminal liability. Presumably, the same conclusion would also apply in civil cases.
2. Did Andersen knowingly participate in the fraud at Enron? Alternatively, was Andersen reckless in overlooking the problems at Enron?
3. Do you accept the concept of unconscious bias as an explanation for the audit failure at Enron?
4. Might the identified factors that amplify unconscious bias—ambiguity, attachment, approval, familiarity, discounting, and escalation—also affect either cor-

[83] *See* HERWITZ & BARRETT, *supra* note 1, at 171.

porate executives and employees generally or lawyers in their relationships with their clients? If so, what can be done to reduce the consequences of such bias?

5. Tax work can fall into three broad categories—return preparation, tax planning and consulting, and tax shelters. In this last category, an advisor, such as an accounting firm, law firm, or investment bank, essentially attempts to use technical quirks in the Internal Revenue Code against the Internal Revenue Service and seeks to sell so-called "products" to companies and corporate executives to reduce taxes. In such an arrangement, the promoter assumes an advocacy role for the buyer. When officers at audit clients purchase such tax shelters, the accounting firm arguably must perform incompatible roles—the audit requires the accounting firm to act as a watchdog of management at the same time that the firm must act as an advocate for the officer in the tax matter. When an audit client purchases a tax shelter, the accounting firm must audit its own advice, which impairs its independence. Because accounting firms tend to sell similar tax-shelters, critics complain that even the attempt to sell a product to a non-audit client impairs independence.

   The Wall Street Journal reported that, during 2002, General Electric Co. paid its auditor, KPMG LLP, more than $21 million in tax fees. Offering another example, the same article points out that Caterpillar Inc. paid its auditor, PricewaterhouseCoopers, $17.4 million for tax work in 2002, more than twice the $8.2 million that the company paid in audit fees. The amount for tax work included $13.9 million "'for services performed as a subcontractor for outside legal counsel.'" For 2003, a spokeswoman at Caterpillar estimated that the amount for tax work would fall to $13.5 million. Cassell Bryan-Low, *Questioning the Books: Keeping the Accountants From Flying High,* WALL ST. J., May 6, 2003, at C1, *available at* 2003 WL-WSJ 3966838; Cassell Bryan-Low, *Accounting Firms Still Earn More From Consulting Fees,* WALL ST. J., Apr. 16, 2003, at C9, *available at* 2003 WL-WSJ 3964987. Should audit committees refuse to preapprove such fees? Should audit committees insist that another accounting firm prepare the company's tax returns and provide tax planning services? Could unconscious bias affect audit committees?