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ENRON PROVIDES LESSONS ON AUDITS FOR ACCOUNTANTS & PUBLIC COMPANIES

by

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The Enron scandal, and the civil and criminal liability exposure arising from it, has created a significant sense of urgency for accountants acting as auditors for public companies, as well as the public companies themselves, to improve the entire system of preparing and releasing financial statements. This LEGAL BACKGROUNDER suggests some ways that auditors and public companies can improve their effectiveness and reduce their liability risk.

Difficult Lessons. Enron and other high-profile cases do not reveal easy lessons about the problems that need addressing. It is important to first consider the following points:

1. This is not a story of the New Economy. Out of the major recent restatement cases (*Enron*, *Waste Management*, *Sunbeam*, *Rite Aid*, *Cendant*, *Livent, Microstrategy, Lucent*), only two involved information technology companies, and neither is an Internet company.

2. Problems do not always arise due to gray areas in Generally Accepted Accounting Principles (GAAP). There were no cutting edge accounting issues involved in such alleged practices as failing to record expenses (*Livent*), missed quarterly cut-offs or phony journal entries (*Cendant*). Even where there are gray areas (as Enron surely will contend), the problem may be not with the decisions reached, but with the lack of disclosure underlying the decisions.[1]

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[1]*See* Lynn E. Turner, *Speech by SEC Staff: The State of Financial Reporting Today: An Unfinished Chapter III* (June 21, 2001) ("The lack of such disclosures in the Waste Management,

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3. This scandal has nothing to do with the requirement under the Private Securities Litigation Reform Act of 1995 that plaintiffs plead a viable fraud claim before they take discovery. The serious allegations in *Enron* and other noteworthy cases were not ferreted out by post-lawsuit discovery allowed under lax pleading standards.

4 If financial fraud exists, it is not for a lack of deterrence. The government regards this as a serious matter.[2] Moreover, notwithstanding the absence of aiding and abetting liability (under *Central Bank*), auditors remain targets for fraud lawsuits and huge settlements.

What's left? Clearly, most finance professionals and corporate executives are not corrupt. Perhaps, however, some corporate actors, structures, and practices have lost sight of the seriousness of purpose required to prepare prudent financial statements and accompanying shareholder disclosures. Especially given the increasing complexity of transactions, this task requires accounting expertise, practical business knowledge, and, above all, a commitment to honorable values. These resources and qualities must be provided by outside auditors, corporate finance professionals, management, and Board of Directors and their Audit Committees.

What Auditors Can Do. What can auditors do to provide the expertise, knowledge, and honorable values required to prepare prudent financial statements and disclosures? Below are some important actions auditors should be considering (as many are):

First, auditors must heighten their awareness of their independent role, as they already have done by indicating that they will not consult for their audit clients. Auditors are not hostile to management. However, other persons and entities are the main customers of audited financial statements: the shareholders, as represented by the Board and its Audit Committee; the SEC; professional peers; and other stakeholders such as employees and lenders. Auditors must treat these persons as their key constituents, if for no other reason than maintaining professional dignity and values. Thus, for example, auditors should bring all issues to the Audit Committee, regardless of their relationship with management, and be firm in insisting that the ethical implications of accounting and disclosure decisions be kept in mind.

Second, in *Enron* and *Sunbeam*, auditors allegedly changed their opinions, notwithstanding knowledge of the facts, between the time they approved revenue recognition on controversial transactions and the time of the respective restatements. *See*, *e.g.*, John A. Byrne, CHAINSAW 349 (1999) (alleging that Sunbeam Controller "sat dumbfounded through the process as auditors . . . disapproved many of the accounting transactions [they] had previously okayed."). The obvious lesson here is prudence: auditors should think carefully before making a judgment that they may have to revisit later. To insure prudence, auditors should consider the effects of disclosure. Assume that others *will* reach an opposite conclusion on issues that can go either way, and that these dissenting judgments will be disclosed. Would the auditor still be willing to support his judgment? If he would, he should increase his level of attention to the disclosure of the issue in the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") and notes accompanying the financial statements.

Third, auditors should support systems that increase the probability of identifying irregularities. They should first insist that companies have *written* policies and procedures for all aspects of accounting and transaction processing, as well as an ethics statement. Most finance personnel are familiar with written policies from their professional training, and this task will stimulate their professional interest in keeping up with current accounting topics.

Sunbeam, and W.R. Grace cases contributed to an inability of investors to understand and analyze the companies' reported results."). (All speeches cited herein are available on the SEC Internet site.)

[2]*See* Lynn E. Turner, *Speech by SEC Staff: Quality, Transparency, Accountability* (Apr. 26, 2001) (listing prison sentences from 2 to 30 years given to 7 CFOs, and potential 5-115 year sentences awaiting 4 other CFOs).

Auditors should next demand the right to access all documents needed for an audit, and to personnel at all levels and divisions of the company. This is a good litmus test to insure that the client recognizes the seriousness of preparing financial statements. And after an auditor has asked for documents, he should ask if there are any documents that he *should* have requested but did not. Auditors also should encourage companies to provide representation letters (*i.e.*, letters stating that the signatory is not aware of any transactions in violation of company policy or accounting rules) from all levels and business units of the company. Increasing the number of reports increases the probability that someone will report a problem if it exists. Similarly, auditors should obtain from as many of a company's customers as is practicable confirmation of material contracts *and* the absence of undocumented terms that would preclude revenue recognition. In addition, auditors must not decline to investigate a potential problem transaction, or acquiesce to an improper accounting treatment of it, based on materiality only (*i.e.*, on the theory that the monetary value of the transaction is insignificant to the financial statements or balance sheet). Finally, the investigation of all issues should be documented. The auditors should retain all their investigation documents to assist in defending against the claim that they recklessly ignored "red flags" signaling trouble.

Fourth, very strong arguments can be made for companies changing auditing firms every 3-4 years. This would encourage auditors to be prudent so as to avoid second-guessing by their successors, and would require improvement in auditing documentation to allow transfer of a client to new auditors. If auditing firms resist these reform, they will have a greater duty to justify their tenure by insuring that *all* auditors on an engagement are trained in the nuances of the client's business and the accounting issues that may arise. Auditors then must tailor their audits or quarterly financial reviews to those risks. For example, *any* instance in which the company sells to a customer and buys from the same customer should invite extremely close attention and a bias on the side of more disclosure. Also, if a large percentage of a company's revenue-generating activities occur at the ends of quarters, auditors should directly observe business at the quarter end. Auditors must pay attention in their work when a client's finance personnel report to business managers, not functionally through the Finance Department. Finally, auditing the balance sheet (as distinguished from the income statement) has regretfully atrophied; the Enron experience should encourage auditors to correct this trend.

What Companies Can Do. Auditors are important, but companies prepare financial statements. What can they do prepare prudent financial statements and disclosures?

The SEC's emphasis on the "tone from the top" is a good start.[3] Having senior management committed to integrity and prudence makes a tremendous difference, although it does not insure that there will not be problems. It is particularly important for management to understand the role of the finance function (both internal and external). Accounting, like all aspects of management, adds shareholder value. But management should not confuse finance with the revenue-generating business of the company. One chilling allegation in *Sunbeam* is that when the CEO noted that the company's financial statements had missed Wall Street forecasts for five consecutive quarters, he chastised the former CFO, "And you delivered these numbers? How could you in good conscience have done that? How could you have supported those forecasts?" Byrne, CHAINSAW, at 3-4 In "good conscience," how could a CFO *not* do that? Accountants don't create financial results, they just report them.

Another critical imperative is improving Audit Committees. This reinforces the seriousness and attention that must be paid to financial statements and disclosures. It also may allow for broader changes. Ultimately, some companies may choose to have their finance personnel report directly to the Audit

[3]*See* Lynn E. Turner, *Speech by SEC Staff: The Investor's Bill of Rights* (June 18, 2001) (calling for "management — from the board of directors on down — that fosters a corporate culture of integrity, honesty and adherence to the spirit as well as the letter of the law" and "who foster a corporate culture in which people don't cut corners just so they can report favorably on the achievement of individual or corporate goals.").

Committee, so as to increase the finance function's independence — a reform that merits very strong consideration.[4] Indeed, some companies may outsource their accounting function entirely, foreclosing even the appearance of manipulating results in order to benefit management.

The SEC now requires Audit Committees to have at least three independent directors, all of whom must be financially literate and one of whom must be a financial professional; and a written charter. These are steps in the right direction, but more can be done:

- One author strongly believes that the SEC should have stuck to the Blue Ribbon Panel's original proposal to require three finance professionals; consider what this would have meant to Enron. In any event, qualification standards should not be satisfied by directors with purely academic experience; practical business experience also is needed.

- Charters should be written with a bias towards *increasing* responsibility, not avoiding it.

- Committees should function with a bias towards holding *more* rather than fewer meetings. This applies to Boards of Directors, too; the Audit Committee is an agent of the Board, not a substitute for it.

- Committee members must recognize that their ultimate constituency is the shareholders and other stakeholders. Thus, they, like auditors, must insist that the company prepare prudent and honorable financial statements and disclosures. Here, it is absolutely crucial that the directors protect finance professionals who may be pressured to do otherwise. The shareholders, in turn, must compensate Board members commensurate with their important responsibilities.

- It is dangerous for companies to let internal finance capabilities, systems, and disciplines atrophy in the belief that the outside auditors will fill the gap at the year end audit. To forestall this, Committees should grade internal finance departments (via a quarterly report) on professional standards, metrics, and disciplines such as the speed in preparing financial statements, the number of errors, and the degree of analytical commentary. Most finance professionals will welcome the involvement and guidance of a competent and active Audit Committee.

- Committees should monitor compliance with the written ethics statement on a quarterly basis. We envision that Committees may expect a quarterly ethics report from all employees; indeed, at least one of the Big Five firms already has started to consult Committees in this effort.

- Committees should consider engaging an outside firm as an adviser on an ongoing basis, *before* an accounting issue has become acute.

- Committees should prepare a standard checklist of questions for the auditors, including whether the auditors were given the full access to people and documents required for their audits. In turn, the auditors or some other party should grade the Committee's effectiveness.

The SEC also seeks to encourage plain language financial statements and discourage pro forma accounting. We think that these goals are worthy but will prove difficult to execute, particularly as the broad liability at issue requires the type of "lawyerly" attention to disclosures that some have decried.

Conclusion. Some may object that the steps advocated here will require an unnecessarily adverse relationship between auditors and the companies they audit. They also may require companies to pay for more auditors and greatly improve their finance staff, systems, control disciplines, and documentation. But we think that auditing firms will recognize that their ultimate clients are the shareholders; and that wise companies will

[4]Thus, Enron's problems may have surfaced sooner had the "whistleblower" sent her memorandum to the Audit Committee, not just the CEO and outside auditors.

understand that the costs of *not* acting are much, much higher. Paying auditors to render their best independent professional advice, based on a complete factual record, will reduce the risk of incurring the tremendous cost of a financial restatement. Moreover, if a problem nevertheless occurs, reliance on an auditor's informed advice may provide a defense to securities fraud liability.