**ENRON’S TENTH ANNIVERSARY: CONTEXT FOR ANDERSEN’S AUDITING FAILURES**

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***Grumpy Old Accountants, November 2011***

We already have discussed the context for Enron’s crimes by describing the Roaring Nineties as a period of accounting exaggeration and worse. We then referenced the first SEC filing that confessed some of the crimes by Enron’s managers. In this and the next essay, we turn our attention to the auditor Arthur Andersen; specifically, we note the context for underauditing during the 1990s in this essay and, in the next, we discuss some specific issues with Andersen’s audits.

We review the gargantuan changes that occurred to the accounting profession in the decade leading up to Enron’s corporate failure. These makeovers diluted the audit process and thus were hurtful to the investment community, though investors and creditors did not become aware of these shortcomings until the first decade of the twenty-first century.

**Mergers of Large Audit Firms**

The first and most obvious change that took place in the 1980s and 1990s was the mergers among several large accounting firms. While there might be some convergence of expertise and some efficiencies from the mergers, there were many downsides as well. Such mergers had the potential to diminish auditing, because the merged firms might consolidate the auditing work while expanding the consulting activities. A less likely but very negative effect could result from a drop-out of yet another firm from the audit business, whether by bankruptcy or by choice, and it would lead to an unacceptably high level of concentration in the industry. The audit oligopoly leads to a concentration of power, but who will benefit?

**Firm Leaders**

The internal transformation of these firms has been even more impressive. The leaders of these firms in times past had stature in the area of accounting theory. They developed and debated what they thought was good policy for the firm and for the profession. Today’s leaders do not possess theoretical bents, but instead have marketing and selling skills. They know how to make money. This orientation raises concerns about the priority of accounting and auditing within the Big Five and the extent of their commitment to the public welfare.

**The Objectives of the AICPA**

The decade before Enron’s collapse saw some incredible changes in the focus of the AICPA. The organization’s leaders downplayed auditing and focused on other, more lucrative areas of profit.

For example, Stu Kessler, past chairman of the AICPA, asserted that we ought to redefine CPA to mean “certified professional adviser.” He proposed replacing “public” with “professional,” which indicates that the AICPA leadership sought to reduce if not abandon its mission to the public. He also proposed to replace “accountant” with “adviser.” He defended this recommendation by asserting that accountants do more than just accounting work, but the public perception of accounting is still riveted on green eye-shades. By changing the name “accountant” to “adviser,” Kessler argued that the profession can convince the public of the burgeoning skills that CPAs possess. His real reason for the proposal seems to have rested with the desire to certify nonaccountants as CPAs. The Big Five might like this, given the metamorphosis of their firms, but the general effect would enervate the accounting profession. Indeed, the mere changes in the philosophy of the AICPA leadership seem to have enervated the profession.

In addition Barry Melachon, AICPA president and chief executive from 1995 to the present, made the incredible statement that the public orientation of the profession can be realized in the marketplace. In other words, satisfying the consumer’s needs by providing appropriate professional services discharges the CPA’s public interest responsibilities. This crass commercial equation turns “public interest” on its head. For decades accountants have understood that the public interest requires CPAs to perform their duties in such a way to instill confidence in society in general and in the marketplace in particular. Apparently making money is more important than the public interest ethic.

**Independence**

Independence, the presumed bedrock of the audit profession, was also under attack during the 1990s. For example, in December 1997 the SEC announced that it had begun an administrative proceeding against KPMG Peat Marwick because KPMG Peat Marwick had created KPMG BayMark, which essentially acted like an investment banker. KPMG audited Porta, which in turn had several business transactions with KPMG BayMark, including a loan to Porta’s president. The SEC argued, correctly in our opinion, that transactions between Porta and BayMark imply that Peat Marwick lost its independence. KPMG vigorously fought this allegation, claiming that it had established organizational firewalls between the audit side of the firm and BayMark and that the transactions were immaterial. Nonetheless, KPMG had dissolved BayMark.

The AICPA also issued a curious document that, among other things, argued against a traditional understanding of independence. The AICPA submitted this document *Serving the Public Interest: A New Conceptual Framework for Auditor Independence* to the Independence Standards Board on October 20, 1997. It sought to redefine and reinterpret independence to allow outsourcing of internal audits and many other activities traditionally deemed inconsistent with independence. Mike Sutton, at the time Chief Accountant at the SEC, wrote a letter on December 11, 1997, to the AICPA that strenuously objected to the White Paper. Sutton and his staff enumerated many problems with the document, but the most serious centered on the purpose of auditing. The SEC objected that the White Paper adopted the viewpoint of the auditor, when the only correct perspective is that of the investor. Our reading of *Serving the Public Interest* demonstrated to us a shocking disregard to independence so audit firms could enjoy more profits.

**Litigation Reform**

Each of the large accounting firms and the AICPA created political action committees (PAC) to influence Congress. These PACs raised huge amounts of money, but they generated large returns as Congress passed so-called litigation reform. Among other things, this reform makes it harder to sue the external auditor and places caps on the penalties.

While these acts helped large accounting firms, it has had detrimental effects on others. Audit effort is a function of the size of the corporation receiving the audit, its complexity, its control system, the probability of becoming sued for a bad audit, and the costs of an audit failure. Litigation reform affects the last two variables. The probability of lawsuit became smaller and the costs of an audit failure less; therefore, audit effort can be reduced. This result benefits auditors since they can curtail audit costs. It hurts others because the chance of finding accounting irregularities decreases, and it is more difficult to redress any problems. Enron might not have become a household word for scandalous behavior if Andersen had computed higher chances of being sued and greater costs of audit failure.

**How Audits Are Conducted**

With megabucks in consulting, it is no wonder that the large accounting firms started treating audits as if they were loss leaders. Small profits or even losses on audit engagements become acceptable as long as the consulting business provides enough profits to make the total service contract lucrative. The difficulty with this approach is that it gives incentives to auditors to cut audit costs wherever they can. Being a loss leader is one thing; having big losses is another. Such incentives might reduce audit effort.

One way of saving money is to employ cheap, inexperienced labor. Audit firms have always done this, and the practice provides excellent training to junior accountants. There is a concern with the growing complexity of the business world whether junior accountants have the ability to detect accounting irregularities. Quality audits may require utilization of more seasoned auditors.

Statistical sampling yields an objective sample size to control risk at acceptable levels. Interestingly, several audit firms rejected statistical sampling, claiming that it produced too high of a sample size. In other words, they would rather use professional judgment and use a smaller audit size and save money.

Firms designed analytical reviews to help them assess the corporation overall and obtain some degree of assurance on the total picture without spending much time or money on lots of audit procedures. The idea is to ascertain whether there are any blips and, if there are, to investigate them. The fallacy of analytical reviews is that finding no blip may actually be a cause of concern; this is especially true as CEOs and CFOs learned how to generate financial pictures with no blips.

**Summary**

The decade before Enron’s demise witnessed a major transformation of the auditing profession. Large accounting firms merged; firm leaders were marketing experts instead of accounting experts; the AICPA began cheerleading for new markets for audit firms, thereby minimizing the importance of auditing; independence was under attack in theory and in practice; Congress passed litigation reform that reduced incentives to perform a high quality audit; and audits became more mechanical as cost-saving methods were employed. The audit environment became less friendly to investors and creditors.

In this environment it is not surprising that the large accounting firms encountered more audit failures. Arthur Andersen had plenty of audit failures, but it was not alone. It is not surprising that a large accounting firm imploded; it could have happened to any of them. We shall explore Andersen’s audit failures in more detail in a later essay.

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*