Accounting Horizons
Vol. 16 No. 2
June 2002
pp. 153–156

Lessons from Enron

James A. Largay III, Editor

Some of you know that I have been the Arthur Andersen & Co. Alumni Professor of Accounting at Lehigh University since 1982. A few will know that my relationship with Andersen goes back to 1963, when, as an undergraduate, I was recruited by Fred Zimmer for a summer internship in Andersen's Chicago office. The legendary Leonard Spacek was just finishing up as Andersen's managing partner. Thus, the string of embarrassments afflicting Andersen—Waste Management, Sunbeam, Boston Chicken, Global Crossings, the Baptist Foundation of Arizona, and Enron—hits me particularly hard.

A Watershed Event

I am not alone in finding the Enron tragedy to be highly instructive, the kind of watershed event that comes along once in a generation or so, the jaws of the kind of disaster from which victory—the good name of the accounting profession—might be snatched. Below I outline some of the lessons to be learned but do not claim to have originated them. Most observers are well aware of the pressures exerted upon the accountancy profession in its role as the public watchdog investors trusted and the countervailing power to corporate financial-reporting interests. Enron is only the latest, most vivid example of the confluence and intensity of those pressures.

Accounting Does Not Cause Companies to Implode, But...

Public accountants do not make their clients' management decisions. Instead, they advise on accounting matters and are to object when management's financial reports fail to provide the transparency necessary to alert the capital markets to the entrails of the corporation's activities. We understand that the information management wants to report regarding their performance can differ from the information investors need to make investment decisions. We also understand how the notion of countervailing power advanced by John Kenneth Galbraith can relate to business and labor, *and* to CFOs and CPAs.[1]

But suppose that management misunderstands the accounting, or that management misinterprets the auditors' explanation of detailed accounting rules to the point that black appears to be white. Can the accounting, which should portray the economic reality resulting from decisions, actually mask that same reality, and persuade insiders that there is no danger? When expert outside accountants and attorneys bless the financial depiction of internal events, many can be misled. Thus the public accountants' responsibility for ensuring that no one is fooled encompasses both the external capital

[1] Galbraith (1956).

markets and the internal decision makers. Although preparers must ultimately bear responsibility for issuing misleading information, expert accounting and legal advisers can inadvertently help preparers deceive themselves, as well as those who rely on the preparers' disclosures.

"Generally Accepted Accounting Principles, If You Know What I Mean" (laughter)

Many will recognize this quotation that makes fun of the loopholes or flexibility in GAAP that can be invoked as support for a variety of financial results. Aware of how this flexibility might exacerbate the tension between managements' and investors' demands for financial information, standard setters saw the need for detailed rules, seeking to keep the corral gates closed. Preparers responsible for applying GAAP, and auditors who review their applications, gradually became dedicated to the proposition that their roles are to comply with the detailed criteria in accounting standards. Some financial-reporting decisions seem driven by the urge to "tick off" the boxes in checklists; participants in the process apparently forgot the goals of fairness, accuracy, and transparency.

In retrospect at least, the "3 percent" rule and other criteria for certifying the independence of Special Purpose Entities (SPEs) seem ludicrous. Adhering to this rule may satisfy preparers and auditors that their decision not to consolidate the SPE will hold up under SEC scrutiny. But does anyone think that this low, arbitrary minimum provides any real comfort that financial reporting is meeting its objectives? I doubt there is a group of standard setters on this earth that can enumerate enough rules to contain those who are intent on circumventing full and fair disclosure. The only answer is the rebirth of professional judgment in an environment characterized by incentives that make the prudent exercise of judgment the only viable alternative. And how is this judgment possible without first understanding the business purpose of transactions? Preparers and auditors must experience an epiphany about the capital markets' need for good information. Those who ignore the light will see their information risk and cost of capital rise.

Independence, or "Who Is The Client?"

Either we all know about the general impossibility of auditor independence espoused by Bazerman et al., or we all suspect the existence of that open secret.[2] Auditors are hired by the client, paid by the client, assisted in employee outplacement efforts by the client, offered lucrative special work by the client, and engaged to structure and bless the client's transactions; what is an audit firm to do when asked to "see it" the client's way? Auditors perform admirably in most settings, but some decide that, like the rest of the Wall Street mavens, they are in business solely to make money. In her discussion of audit firm size and audit quality, Linda DeAngelo posits the existence of a stream of client-specific quasi-economic rents.[3] Fear of losing these returns due to loss of reputation induces large firms to perform quality audits. Perhaps the growing significance of quasi-economic rents from nonaudit services overwhelms concerns about reputation that used to safeguard the audit fee stream.

[2] Bazerman et al. (1997).

[3] DeAngelo (1981).

Doesn't it seem obvious that providing nonaudit services to clients should be tightly constrained to tax advice and other services not easily separated from the audit? All the talent that CPA firms need can be retained if they perform the full array of consulting services for the audit clients of *other* CPA firms. This might introduce some inefficiencies into audits, but I think the pendulum has shifted away from favoring the low-cost cozy "efficiencies" of the past to embrace more arm's-length relationships that enhance independence. Likewise, mandatory rotation of audit firms, on three- to five-year cycles, is an old idea whose time has come.

Here, as Elsewhere, Education Is a Key Solution

Baruch Lev recently observed "the deteriorating capabilities of entry-level personnel. In the 1980s, accounting firms essentially stopped recruiting pricey MBAs, shifting [entirely] to accounting undergraduates who, while capable, lack experience and advanced business education."[4] The large accounting firms reached much the same conclusion years ago when the then Big 8 managing partners released the famous White Paper that coincided with the so-called 150-hour rule requiring education beyond the undergraduate program.[5] These chief executives recognized the explosion in the body of knowledge, the growing complexity of business arrangements and transactions, and the various softer skills needed to function effectively in a client service environment. The AICPA membership adopted this new educational requirement overwhelmingly.

Now the word is that some of the surviving Big 5 accounting firms, and others, are seeking to repeal this educational requirement, either by refusing to adequately compensate new professionals for their added education and skills, by lobbying state societies and lawmakers for its repeal, or by recommending that CPE credits be substituted for college credits. This opposition could hardly come at a worse time, a time when auditors need more capabilities, not fewer. My colleague, Jack Paul, reminds me that dedicating some of the additional education to studying and learning from audit failures can reduce recidivism. Over 30 years ago, the sensational Continental Vending case addressed related-party transactions of the Enron variety.[6] How many undergraduate students, or auditors in the field, ever heard of Continental Vending and its lessons for their work? In the short run, relaxing educational requirements might lead to a modest spike in the supply of new accountants, but in the longer run, the firms will find themselves increasingly outclassed by better-qualified client personnel.

Going Forward

So let's view the Enron watershed as an opportunity to reinvigorate professional judgment, stress the fairness of financial statements and their ability to portray economic reality, solidify the independence of the gatekeepers, and more effectively educate those charged with protecting the public interest. And I hope you responded to our Call for Papers on the Quality of Earnings! Whatever things Enron had going for it in recent years, high-quality earnings was not among them.

---

4 Lev (2002).
5 *Perspectives* (1989).
6 *United States v. Simon* (1969).

REFERENCES

Bazerman, M. H., K. P. Morgan, and G. F. Loewenstein. 1997. The impossibility of auditor independence. *Sloan Management Review* (Summer): 122–127.

DeAngelo, L. E. 1981. Auditor size and audit quality. *Journal of Accounting and Economics* (December): 183–199.

Galbraith, J. K. 1956. *American Capitalism: The Concept of Countervailing Power*. Revised Edition. Boston, MA: Houghton Mifflin Co.

Lev, B. 2002. Too gray for its own good. *Wall Street Journal* (January 22): C1.

Perspectives of Education: Capabilities for Success in the Accounting Profession (The White Paper). 1989. Arthur Andersen & Co., Arthur Young, Coopers & Lybrand, Deloitte Haskins & Sells, Ernst & Whinney, Peat Marwick Main & Co., Price Waterhouse, and Touche Ross. New York, NY.

United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert denied*, 397 U.S. 1006 (1970).