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THE ENRON COLLAPSE

Why auditors weren't likely to blow whistle

Arthur M. Louis, Chronicle Staff Writer

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The angry breakup between Enron, the bankrupt energy trader, and Andersen,

its erstwhile auditor, demonstrates once again that the investing public can't necessarily expect auditors to protect them.

Enron's bankruptcy has focused glaring attention on Andersen, one of the Big Five accounting firms, which audited the company's books until Enron fired it on Thursday.

Congressional investigators, not to mention class-action lawyers, are sifting through allegations that Enron used questionable accounting practices to misrepresent its true financial condition until bankruptcy was inescapable, and that Andersen -- the watchdog assigned to warn the public of such things --

let it happen.

Much of the controversy centers on Enron's establishment of numerous "special purpose entities" -- side partnerships that raised capital for the company without adding debt to its balance sheet. This left the impression that Enron was less heavily leveraged than it was.

Some accounting experts contend that not all the Enron SPEs qualified for off-balance-sheet treatment and that Andersen should have said so to Enron's management.

However, because of the way the auditing system works, even the strictest and purest auditors often let a potential financial disaster get past them. If a company is intent on deceiving the investing public, there is little the auditor can do to discover and prevent it.

Auditors are independent, outside firms, hired by publicly held companies to audit their books because securities law requires it.

The purpose of the audit is to determine whether a company's financial statements fairly reflect its condition, within the broad parameters of what the professionals call "generally accepted accounting principles."

But even the biggest auditors don't have the time or resources to inspect every financial document -- every invoice, receipt or memorandum connected with every financial transaction generated by a large, modern corporation.

"The role of the audit is not to verify 100 percent the accuracy of all the financial records," says Reuven Lehavy, professor of accounting at the Haas School of Business at the University of California at Berkeley.

Instead, he notes, the auditors lean on the laws of probability -- running tests here, perusing documents there, asking for corroborating information, following the paper trails in what they hope will be a statistically meaningful sample of financial material.

They also ask management about the accounting principles and estimates that underlie the numbers in the company's financial statements.

If the company scores perfect on this necessarily limited series of tests, then the auditors assume - - though they can't prove -- that the financial reports are fair and square, and they will say so in the company's annual report.

But that certainly doesn't mean that financial irregularities won't surface later. In fact, there have been plenty of examples in recent years of financial statements that came back to bite auditors.

Rite Aid Corp., for example, overstated its profit by more than \$1 billion a few years ago, despite the auditing of the KPMG accounting firm. Cendant Corp. perpetrated a multimillion-dollar accounting fraud under the watchful eye of Ernst & Young. And Andersen itself failed to report hidden financial problems at Sunbeam Corp. and Waste Management Inc.

While the litany of unpleasant surprises is a long one, accounting experts can't think of a single instance in which an auditor was the first to publicly blow the whistle on a client.

When auditors unearth accounting behavior that they consider fishy, and if they can't get management to make changes, their normal practice is to resign the account without fanfare.

Many critics contend that auditors are simply too cozy with their clients --

that they often don't operate at arm's length. After all, the companies they audit are the ones who pay for their services.

Andersen, for example, has acknowledged that the partner who ran its audits at Enron ordered the destruction of certain documents after it was learned that federal regulators were investigating Enron's financial practices. Andersen fired the partner this week.

Companies and their auditors also tend to be entwined in other financial relationships. Most accounting firms also provide their audit clients with consulting services, such as helping to run the personnel, technology, legal and financial departments.

At Enron, Andersen was paid \$25 million to audit the books and an additional \$27 million for consulting.

One of Andersen's consulting chores at Enron was to provide internal auditing services, which means that one arm of Andersen was responsible for generating financial reports that were audited by another arm -- a potential conflict of interest within a conflict of interest.

Burton Malkiel, a celebrated economics professor at Princeton University, suggested recently that companies be required to change auditors periodically to break up the cozy relationships and minimize conflicts of interest.

Such a rule would make auditors more careful, Malkiel says, because they would fear having their mistakes exposed by the competing accounting firms that replace them.

But the Haas School's Lehigh warns that such a rule "could generate unnecessary costs to the economy" as auditors constantly struggle to acquaint themselves with the finances of new clients.

"I would be sort of careful about generalizing too much from the Enron incident and using it as a reason to introduce regulations that may actually impede or reduce an auditor's ability to do the job right," he adds.

A much more radical proposal was put forward a couple of years ago by Arthur Levitt Jr., then chairman of the Securities and Exchange Commission. He said auditors should simply be banned from most consulting roles with the companies they audit.

The proposal met with unanimous and vigorous opposition from the accounting industry, and the normally tigerish Levitt backed down.

Although the SEC and Congress will get involved when a major crisis arises, there is no government agency regulating the accounting industry on a day-to-day basis. The industry is essentially self-regulated.

However, the principal self-regulatory body, called the Public Oversight Board, doesn't have the power to mete out punishments. It can only investigate alleged improprieties and jawbone the firms involved.

Levitt's successor as head of the SEC, Harvey Pitt -- who as a private attorney represented some of the leading accounting firms -- disclosed plans this week to establish a new body, under SEC oversight, to regulate the accounting industry.

It would include "public members," not just practicing accountants, and would investigate auditing improprieties. It would refer evidence of criminal behavior to the justice system.

E-mail Arthur Louis at alouis@sfgate.com.

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