

Enron Demonstrates Weakness in the Attestation Process

By Joseph L. Leauanae and Derk G. Rasmussen

Enron

In May, the SEC announced that it had begun investigating Enron's recent disclosure that it overstated the value of its assets by up to \$24 billion in the last year. The SEC is now focusing on how the company valued everything from trading activities to hard assets such as investments in power plants and fiber optic networks. Specifically, the SEC is seeking to determine how and when the downgraded assets were placed on the balance sheet, whether their value was artificially inflated, and which executives were involved in those decisions.

Throughout the period of the alleged financial statement manipulation, Andersen acted not only as Enron's outside independent auditor but also as a consultant. This dual function is currently under intense scrutiny by Congress.

The Enron case has demonstrably exposed some of the inherent weaknesses within the current attestation process.

Lack of Objectivity

In attempting to retain large clients and the associated fees generated in serving them, independent auditors can suffer impaired objectivity, due in no small way to the loose restrictions that govern firms providing audits and related consulting services. These loose restrictions can effectively grant leniency in the way companies being audited account for financial transactions. It is this leniency and those financial transactions that later come back to haunt both the companies and their auditors.

Further weakening auditor objectivity is the fact that fees generated under the umbrella of consulting services often have the potential to be far greater than those generated under the provisions of standard audit services. In our opinion, if CPAs act as both consultants, who are often integrated into the corporate framework, and independent auditors, who are supposedly disinterested, such positioning will lead to the conflicts of interest warned against by the AICPA. When conflicts of interest arise, CPAs are often faced with ethical decisions. Unfortunately, these ethical dilemmas are not always resolved on the side of caution.

Failure to critically analyze

Contemporary audit training has a tendency to emphasize adherence to an audit program, which is generally no more than a checklist that must be “ticked and tied” to a company’s financial statements. Unfortunately this type of audit training has been carried out at the expense of more comprehensive techniques that focus on analytical thinking and critical analysis. Without analytical thinking and critical analysis, how can auditors substantively determine that the financial statements being audited are not misstated or misleading?

In the current accounting environment, an auditor is generally shipped to the front lines after only a minimal amount of formal audit training. Most hands-on training takes place at the client site, where the effectiveness of the auditor will be dependent on the effectiveness of the instructor. Without specific training in the science and art of analytical thinking and critical analysis, an auditor cannot be completely effective. Since not all audit partners and managers are created equal, not all neophyte auditors receive the effective training that they need.

In addition to training deficiencies, common mistakes of logic and laziness also impair the execution of certain audit engagements. Looking beyond the quantitative aspects of an audit, there are many times when things just “don’t feel right.” Those are the instances when auditors, possibly without recognizing it, can subconsciously apply analytical thinking and critical analysis.

If auditors could be trained to cognitively use these skills -- which in turn would improve their ability to adequately observe, understand, and process misleading representations on the financial statements that they audit -- the quality of many audits would improve dramatically. Analytical thinking and critical analysis are skills embedded in legal training; these skills should also be cultivated in the training of accountants.

Put succinctly, effective training will allow auditors to answer the question: does this make economic sense? Sometimes it is possible to have technical compliance with GAAP and still miss the mark, such as when an auditor verifies that a sales transaction is adequately collateralized but ignores the fair market value of the assets being acquired. These oversights of form over substance only weaken the effectiveness of an audit.

Failure to recognize limitations to expertise

Sometimes, however, avoiding conflicts of interest and applying analytical thought and critical analysis are not enough. Many audit engagements involve complex issues that often fall outside the realm of an auditor’s expertise. Even though many large CPA firms have the in-house ability, outside of the audit department, to address these issues, they are required to avoid even the appearance that conflicts of interest exist. Therefore, in order to avoid perceived conflicts of interest, auditors must assess the limitations to their expertise and, if necessary, ask that complex issues exceeding their expertise be resolved by qualified professionals who are not associated with their firm. Examples of these types of

issues include conducting business valuations that may involve the appraisal of subsidiaries and applying forensic accounting specifically for purposes of reconstructing financial statements or identifying fraud.

The examples listed above were key issues in the Enron case. The value of various energy projects at various points in time was an important criterion in determining whether or not the financial statements were misstated or misleading. Had these projects been valued at the time by a professional who was proficient in the appraisal of income producing energy projects, these misstatements may have been avoided.

Conclusions

Fundamental changes in how audits and related consulting services are sold, maintained, managed, and performed, are necessary to improve the quality of audited financial statements. Avoiding situations that might impair objectivity, recognizing the failure to critically analyze, and acknowledging limitations to expertise, are primary factors that contributed to the deficiencies in the Enron audits. Until the audit profession is willing to address the weaknesses within current audit processes, and focus its educational and professional resources on identifying and implementing solutions, debacles like Enron will continue to occur.