Sage FORENSIC ACCOUNTING

Truth or Dare: Assessing the Reliability of Financial Statements

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How important are financial statements?

To investors, financial statements are the last line of defense in protecting their investment. Financial statements are very often the only opportunity that investors are given to assess both an organization's viability and its life expectancy.

To creditors, financial statements represent the ability of an organization to repay debts. Creditors gravitate towards financial statements because they generally like to function under the principle of reciprocity: if they give it, they would like to eventually get it back.

To government, financial statements are a two-fold issue: they determine how much the IRS can levy and they also create a burden on the powers that be, through the Securities and Exchange Commission (SEC) and other similar entities, to prevent the collapse of capitalism.

To accountants, financial statements represent both a source of ongoing fees and a Pandora's box of potential liability. If financial statements issued by a CPA or a CPA firm are eventually exposed as misleading, whether intentional or not, the accountant or firm that is responsible must face the sometimes dramatic consequences.

Who is responsible for adjudicating the integrity of company-issued financial statements? In most instances that responsibility falls squarely on the shoulders of supposedly independent auditors. However, with intense competition for large audit clients, and given the potential fee generation from such long-term engagements, these accountants must face difficult ethical questions if they want to both "do the right thing" and continue to maintain their lucrative client relationships.

THE PROBLEMS WITH MISLEADING FINANCIAL STATEMENTS

Misleading financial statements can take many forms. The errors or omissions may be relatively minor or they may be significant. The problem, however, is that because of the multiple interests of those who rely on financial statements, even minor errors or omissions can prove disastrous.

Investors rely heavily on the objectivity and integrity of those who prepare financial statements. When that fiduciary bond is broken, and the reliability of financial statements is called into question, any confidence that may have been invested in the reporting system is destroyed. In the eyes of the investor, if the financial statements cannot be trusted, what else might be wrong?

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Both creditors and investors have similar interests in mind when they assess an organization's ability to repay debt. Since investments are the lifeblood of most companies, especially those companies that are publicly traded, the fear that financial statements may be misleading will discourage debt and equity infusions. In turn, the inability to reasonably access capital markets can seriously impair a company's ability to grow.

If the financial reporting system is working properly, the financial statements issued by a company will be reliable. If the financial reporting system is not functioning properly, then the means and methods to mislead are readily available to be abused.

ENRON – DÉJÀ VU IN UTAH

Enron may be receiving its share of publicity today, but the types of financial statement concerns that put Enron in the hot seat have been seen before. In Utah, similar issues came into play in the Bonneville Pacific Corporation (Bonneville Pacific) bankruptcy. These complex issues are rife with conflict and usually end up occupying the attention of bankruptcy court, bankruptcy attorneys, and forensic accountants.

Bonneville Pacific

In Utah, during the late 1980s and early 1990s, the alternative energy company Bonneville Pacific, and its officers, were accused of using related parties, with offshore ties, to augment or "prop up" certain sales transactions. The results of these transactions increased both the revenues and the assets of Bonneville Pacific. During the Bonneville Pacific bankruptcy proceeding, there was considerable debate over the role of related parties and who had knowledge of these related parties. Part of the debate centered on how much the auditors of Bonneville Pacific knew or should have known about the related parties.

In one transaction, Bonneville Pacific packaged interests in several alternative energy projects and sold these interests to an unrelated third party for cash and a note receivable. The cash and note receivable were then used by Bonneville Pacific to acquire a very large alternative energy project. Ultimately, it was determined that the source of the cash used by the unrelated third party to acquire the Bonneville Pacific assets came in the form of a loan from an entity with ties to Bonneville Pacific officers. It was also discovered that the unrelated third party entity with ties to Bonneville Pacific officers had received part of the money used to purchase the Bonneville Pacific assets via a loan from Bonneville Pacific itself.

The key accounting issues in this transaction, other than those pertaining to the related party, included the underlying value of the interests sold to the third party as well as the value of the large alternative energy project that was acquired. Bonneville Pacific officers argued that the value of the interests sold to the third party and the value of the large project acquired were supportable and representative of fair market

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value. Obviously, if this had been the case, the related party aspects of the transaction would have been less meaningful and would have fallen within the realm of "no harm, no foul." The key question that arises at this point in the analysis, however, is: what were the assets really worth at the time that the transaction was completed, and did subsequent events have an impact on the fair market value of the assets?

During the bankruptcy there were significant issues regarding who knew what and when. Had the auditors and other professionals who were retained to advise the company been informed of the transactions' true nature or did management play "hide the ball?" Were asset values inflated to allow aggressive revenue recognition or did subsequent economic events cause a decline in energy project values?

These and other questions plagued the Bonneville Pacific case. By the time that the dust settled, company officers had been sentenced to prison and the lives of many more employees, investors, and creditors had been severely impacted.

More than a decade later, the troubled specter of the Bonneville Pacific case reemerged in Houston, interestingly enough to haunt another energy company.

Enron

Enron Corporation (Enron) was formed in 1985 and grew from a small midwestern gas pipeline company into the world's largest energy trader. Although the company ran operations efficiently, it wasn't until after the Federal Energy Regulatory Commission initiated the deregulation of energy markets, in the latter part of the 1990s, that the spectacular rise of the Enron empire truly began.

In 1999, the Board of Directors allegedly waived ethics rules and permitted Enron's chief financial officer to keep his position while simultaneously running complex transactions through private partnerships, known as special purpose entities or special purpose vehicles (SPEs), which would buy and sell assets from and to the company. By 2001, Enron's annual report listed approximately 3,800 of these partnerships and subsidiaries, of which more than 700 were located in the Cayman Islands or other offshore financial havens.

During the period subsequent to 1999, the CFO and a few other employees allegedly became unjustly enriched, through this network of SPEs, by millions of dollars. This unjust enrichment, it is asserted, was a result of the manipulation of Enron's financial statements. During this time, the Board remained conspicuously quiet, neglecting to either monitor the CFO's activities or track his transactional profits.

As it turned out, the personal enrichment of Enron employees was only one aspect of a much more serious problem. Some of the SPEs, including Chewco, LJM1, and LJM2, were used by Enron to enter into transactions that they either could not, or would not, consummate with unrelated commercial entities.

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Many of the most significant transactions were apparently designed to portray favorable financial statement results, rather than to achieve true economic objectives or to transfer risk. A number of these transactions were formulated such that, had they followed applicable accounting rules, the company could have kept assets and liabilities, primarily debt, from showing up on its balance sheet. Unfortunately, said transactions did not adhere to the appropriate accounting guidelines.

Other transactions were improperly implemented to offset losses. Transactions executed at the direction of the CFO were made on terms that were allegedly unfair to Enron and had little economic substance. The transactions allowed the company to conceal extremely large losses resulting from their investments by fabricating the appearance that a third party was obligated to pay Enron the amount of those losses, when in fact that third party was no more than a shell entity in which Enron was the primary shareholder.

In one transaction that took place in 2000, the CFO allegedly offered a group of Enron employees the opportunity to invest in Southampton Place, a partnership that provided extraordinary returns. After little more than two months, a $25,000 investment in Southampton netted the CFO approximately $4.5 million. Two other employees, investing just $5,800 each, received $1 million apiece during that same period of time.

Under escalating media pressure, the Board finally initiated an official investigation into the related party transactions. What the Board uncovered were partnerships established primarily to enrich the CFO, rather than to benefit Enron. At the time of this discovery, the CFO had already allegedly generated $30 million for his own benefit. A report issued by the special investigating panel appointed by the Board indicated that the partnership transactions had hidden huge Enron losses from the investing public and resulted in nearly $1 billion in overstated profits during the 12 months prior to the third quarter of 2001. The disclosure, which seemed to confirm that Enron's financial statements had been blatantly manipulated, triggered a drop in Enron's stock price that tragically cost shareholders and employees billions of dollars and prompted multiple congressional and federal investigations into the company's accounting practices and policies.

According to the special investigating panel report, "The tragic consequences [of mishandling the partnerships] were the result of failures at many levels and by many people: a flawed idea, self-enrichment by employees, inadequately-designed controls, poor implementation, inattentive oversight, simple (and not so simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits."

In May of this year the SEC announced that it had begun investigating the company's recent disclosure that it may have overstated the value of its assets by up to $24 billion in the last year, focusing on how the company valued everything from its trading activities to its hard assets like investments in power plants and fiber optic networks. Specifically, the SEC is seeking to determine how and when the assets to be downgraded were placed on the balance sheet, whether or not their value was artificially inflated, and which executives were involved in those decisions.

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Throughout this period of alleged financial statement manipulation, the Chicago-based CPA firm of Andersen acted not only as Enron's outside independent auditing firm, engaged to ensure that the company's financial records complied with financial disclosure standards, but also as the company's consultants. This dual function, which may have subjected Andersen to a conflict of interest, is currently under intense scrutiny by Congress.

THE BONNEVILLE PACIFIC AND ENRON CONNECTION

Most of the similarities between Bonneville Pacific and Enron are readily apparent. They were both energy companies. They both may have been engaged in a multitude of related-party transactions involving revenue manipulation and offshore entities. They were both accused of being aggressive in revenue recognition and asset valuation. And they both retained well-known CPA firms to audit their financial statements.

THE CPA'S CONTRIBUTION TO AUDITED FINANCIAL MISSTATEMENTS

Most financial statements are compiled, reviewed, and audited by CPAs. CPAs are usually members of the American Institute of Certified Public Accountants (AICPA), a prominent and ethics-driven organization. CPAs have traditionally been a pillar of trust and respectability in the financial world.

How, then, is it possible for CPAs and CPA firms to contribute to misleading audited financial statements?

The answer, in our opinion, is due to the following: CPAs/auditors are sometimes put into a position where they have conflicting interests; CPAs/auditors do not always critically analyze the key economic and financial components of the financial statements that they audit; and CPAs/auditors do not always recognize the limitations to their own expertise.

Conflicts of interest

CPAs are sometimes asked to be both dispassionately indifferent, as an objective third party, and intimately involved, as a consultant or advocate for the company. When this conflict is extrapolated from a single CPA to an entire CPA firm, it is easy to see how independence can quickly become a murky compliance issue. This lack of independence goes some way to explaining how, even with the best intentions, such conflicts can result in misleading audited financial statements.

The AICPA mandates the following in regards to a CPA's objectivity and independence:

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> Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services…
>
> For a member in public practice, the maintenance of objectivity and independence requires a continuing assessment of client relationships and public responsibility. Such a member who provides auditing and other attestation services should be independent in fact and appearance. In providing all other services, a member should maintain objectivity and avoid conflicts of interest.
>
> [Source: AICPA Code of Professional Conduct - Principles of Professional Conduct - Section 55 - Article IV: Objectivity and Independence]

As the AICPA is quick to point out, CPAs who provide audit services must avoid even the appearance of conflicting interests. According to allegations in the cases of both Bonneville Pacific and Enron, corporate management and the companies' independent auditors were far too closely aligned.

In attempting to retain large clients and the associated fees generated in servicing them, independent auditors can often have their objectivity impaired by loosening the restrictions that should govern their audits, effectively granting leniency in the way that the company being audited accounts for financial transactions. It is this leniency and those financial transactions that later come back to haunt both the company and its auditors.

Further weakening auditors' 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. This realization leads auditors in many instances to "give away" audit work in order to capture increased corporate tax and consulting 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 consistently emphasized adherence to an audit program, or a checklist that must be "ticked and tied" to a company's financial statements during the performance of an audit. This type of audit training, however, 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? It is our opinion that sound analytical thinking should be the guiding force behind Generally Accepted Accounting Principles (GAAP).

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Winston Churchill once said, "Give us the tools, and we will finish the job."

Unfortunately, although some might disagree, the value of the finished job is often dependent on the quality of the tools used to complete it. In the current accounting environment an auditor is generally shipped to the front lines after only a minimal amount of formal audit training. Most of their hands-on training takes place at the client site, where the effectiveness of the auditor will be dependent on the effectiveness of their 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 serve to 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 an auditor, possibly without recognizing it, has subconsciously applied 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 should 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.

If current audit training and the standards that govern audit requirements can be modified to incorporate more analytical thinking and critical analysis, a number of prevalent mistakes could be avoided, and auditors will be better prepared to analyze the economic aspects of a financial statement, rather than just the formulaic conformance of a financial statement to predetermined criteria.

Not recognizing 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 auditors' 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, have complex issues that exceed their expertise be

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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 Bonneville Pacific and Enron cases. The value of 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.

Identifying that conflicts of interest, the failure to critically analyze, and not recognizing limitations to expertise can be primary factors in the failure of an audit is helpful. But unless we capitalize on this knowledge to prevent situations like Enron from happening again, they will.

CONCLUSIONS

Without fundamental changes in how audits and related consulting services are sold, maintained, managed, and performed, the quality of audited financial statements will not improve. If the check-and-balance system that is the contemporary audit process is allowed to continue unabated and uncorrected, the troubled specter of Enron will return, again.

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