

## **Arthur Anderson Auditors and Enron: What happened to their Texas CPA licenses?**

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### **ABSTRACT**

This article examines Arthur Andersen, its role with Enron, and what happened to some of its key players. The demise of Arthur Andersen and Enron was significant. Thousands of people lost their jobs and investments. As a result, new laws for publicly traded companies and auditing firms followed. Auditing firms and Certified Public Accountants (CPA) are licensed and disciplined by each state where audits or work is performed. Enron's headquarters and many of the allegations against Arthur Andersen occurred in Texas and under the jurisdiction of the Texas State Board of Public Accountancy. With significant damage to the accounting profession, only a few individuals were disciplined. This paper explores the history of Arthur Andersen, its client Enron, and what happened to those involved following the collapse of the two.

Keywords, Anderson Auditors Auditor's, Enron, CPA license

## INTRODUCTION

Who would invest in a company without reliable financial statements? Integrity is the hallmark of the accounting profession and stakeholders rely on their work product. Arguably, one of the most respected and successful (at the time) accounting firms in history disappeared due to the actions of a few. Many lost their life savings, jobs, homes, and confidence in the financial system. The demise of the public accounting firm Arthur Andersen and one of its clientele, Enron contributed to drastic changes for publicly held companies, accountants, managers, and others. What is the history of Arthur Andersen and how did it collapse? What happened to those professionals involved with the scandal at Arthur Andersen?

Arthur Andersen was once known as a major player of the Big 5 accounting firms (SEC, 2008) and now has dwindled to just a small LLP. At one time, the firm employed 28,000 in the US and 85,000 worldwide with revenues of \$9.3 billion (Wikipedia, 2008). To understand the ending of this historical accounting giant, you must know its history. The young days of the firm are nothing to forget; the founder of this once well respected organization began his career at the age of 23 as the youngest certified accountant in Illinois (Goff, 2002). Arthur E. Andersen, an accounting professor at Northwestern University, formed a partnership with Clarence M. Delaney in 1913 in which they purchased a small accounting firm in Chicago that would become known as Andersen, Delaney, & Co (Carnegie, 2005). The partners split in 1918 and the firm became Arthur Andersen. Mr. Andersen was a man with a mission; he wanted to create an organization that was more than “just another accounting firm,” but to be honest and to “think straight and talk straight”, a phrase Mr. Andersen learned in childhood (Carnegie, 2005). His death in 1947, and succession by Leonard Spacek, led to a period of very successful times for the firm. The first international office was opened in the 1950s, with revenues around \$8 million and in the late 1970s, with revenues around \$130 million (Goff, 2002). The number of partners at the firm surpassed 1,000 people. When the firm’s successful consulting division split from Arthur Andersen, renaming itself Accenture, the top accounting firm emerged from the deal as number five and with a focus more on its audit services. During these high times, the firm engaged Enron as a client, in 1986. Andersen provided Enron, through the years, with external and internal auditing, as well as consulting services. Little did many know that this 16 year relationship would become the demise of the firm and its client, Enron.

Enron was created in 1985 through a merger of Houston Natural Gas and InterNorth, after federal deregulation of natural gas pipelines. This merger brought large amounts of debt to Enron and the company’s drive to find alternative means of success and profits (Thomas, 2002). CEO Ken Lay, hired Jeffrey Skilling as a consultant, to create a solution for the company’s problem. His solution was to “create a ‘gas bank’ in which Enron would buy gas from a network of suppliers and sell it to a network of consumers, contractually guaranteeing both the supply and the price, charging fees for the transactions and assuming the associated risks;” Enron had then become a trading business with its product, the energy derivative (Thomas, 2002). This new venture impressed the CEO and in 1990 he hired Skilling to head up Enron’s new finance division. Recruiting only the best, Skilling enlisted a young Andrew Fastow; he moved up quickly and found himself as CFO in 1998. “As Skilling oversaw the building of the company’s vast trading operations, Fastow oversaw its financing by ever more complicated means” (Thomas, 2002).

In the mid 1990s, “mark to market” accounting became acceptable and Skilling applied it to the energy trading business. “Under mark to market rules, whenever companies have

outstanding energy-related or other derivative contracts (either assets or liabilities) on their balance sheets at the end of a particular quarter, they must adjust them to fair market value, booking unrealized gains or losses to the income statement for the period;" however, long term future contracts for commodities such as gas are difficult to ascertain market values, typically no quoted prices are available (Thomas, 2002). This leaves room for companies to develop its own valuation models as well as room for manipulation.

With debt still visible, financial analysis' ratings for Enron were lower than the company desired. Andy Fastow, Enron's CFO, led the company in the use of special purpose entities (SPEs) to increase capital and improve Enron's rating. SPEs are partnerships with an outside party that allow the company to increase its ROA and leverage without required reporting of debt on the company's financial statements. Thus, Fastow was able to hide Enron's debt through approximately 500 SPEs (Reinstein & Weirich, 2002), including "troubled" hard assets such as overseas energy plants and broadband operations (Thomas, 2002). These entities are required to have at least a 3% interest from an independent party to qualify for the off balance sheet requirement; if the interest requirement is not reached, the entity must be reported as a subsidiary to the parent company. Moreover, related party transactions hindered transparent financial statements. Risk for these entities was assumed by Enron and not the outside party, yet were not completely independent.

These said transactions, based on Arthur Andersen's risk assessment, were risky; however, audit procedures did not reflect consideration of this risk. Enron actions were questionable and millions in fees generated, perhaps Andersen looked the other way.

The culmination of Andersen's demise was with its surrendering of its public practice licenses in 2002 due to relationship with their client, Enron. The firm successfully appealed the criminal charges of obstruction of justice and continues to defend itself in civil lawsuits. Where have its auditors gone; are they still practicing, consulting, or even engaged in business? This paper will address these questions.

State Boards of Public Accountancy administer and enforce the CPA designation and licensure. When a licensed CPA violates specified regulations, the Board has the responsibility to investigate and take appropriate action, including revocation of a CPA license held by an individual or entity.

Arthur Andersen was once known as a major player in the accounting profession. The firm engaged Enron as a client, in 1986. Andersen provided Enron, through the years, with external and internal auditing, as well as consulting services. The engagement team for Enron consisted of several key people. This paper, based on publicly available documents, follows the chain of command starting from the bottom with staff auditors up to the key engagement partner.

Derek Claybrook worked on the 1997 and 1998 JEDI (subsidiary of Enron) Audit as well as the Enron Capital & Trade (ECT) portion of the Enron Audit. In 2005, the Texas State Board of Public Accountancy (TSBPA) charged him with failure to properly complete or follow audit procedures and that he knew of the JEDI related party transactions but failed to disclose them in audit papers. According to the TSBPA database, Mr. Claybrook possesses a current Texas CPA license (TSBPA, D.B. Claybrook, n.d.).

Jennifer Stevenson was an engagement senior for the 1997 JEDI and ECT Audit. She was responsible for following Andersen Audit Objectives and Procedures (AOP), Generally Accepted Audit Standards (GAAS) and TSBPA rules. According to the complaint filed by the TSBPA, against Ms. Stevenson in 2005, she failed to discover related party transactions, as well as supervise Derek Claybrook in the analysis of these transactions. In November 2008, the

TSBPA announced that the previous filed complaint against Mrs. Jennifer Stevenson Jackson was voted by the Board to be dismissed (TSBPA, 2008).

James Brown, Jr. was an engagement manager for the 1997 JEDI Audit as well as the 1997 and 1998 ECT Audit. In November 2005, the TSBPA filed charges against James Brown, Jr. for failure to properly conduct audit procedures, thus not discovering related party transactions between JEDI and CHEWCO (Enron subsidiary), properly document audit procedures, and provide supervision to junior staff auditors (TSBPA, 2005). Subsequently, the TSBPA voted to dismiss the complaint against Mr. Brown (TSBPA, 2008). The TSBPA database reports that Mr. Brown still maintains his license in the state of Texas with no reported disciplinary history (TSBPA, J.J. Brown, Jr., n.d.).

Andrew Schuleman worked on the 1997 JEDI Audit. He was an engagement senior on the 1998 ECT Audit and was an engagement manager for the 1998 JEDI Audit. In November 2005, the TSBPA with alleged that Mr. Schuleman failed to adequately perform audit procedures on the changes in the 1998 JEDI partnership; in doing so, he should have known that Enron controlled JEDI as well as CHEWCO (subsidiary of Enron). Additionally, Mr. Schuleman failed to take exception to "ECT's recording of the \$25.7 million in earnings in the first quarter of 1998 and he failed to respond to the implications of re-characterizing these earnings as a 'required fee'" (TSBPA, 2005). According to the TSBPA database, Mr. Schuleman allegedly violated Auditing Standards; the board determined that he should receive a public reprimand. Mr. Schuleman has currently maintains his CPA license in Texas (TSBPA, A.M. Schuleman, n.d.).

Patricia Grutzmacher was the engagement manager for the 1997 and 1998 ECT Audit, as well as the 1998 JEDI Audit. In November 2005, the TSBPA filed a disciplinary action charge against Ms. Grutzmacher due to her involvement with the audits of Enron and its subsidiaries. Ms. Grutzmacher was responsible for ascertaining whether CHEWCO qualified for off balance sheet treatment; in her audit procedures, she failed to properly apply audit procedures to CHEWCO transactions for this determination, as well as to document audit steps in her work papers, and she relied upon management assertions in conducting the audit (TSBPA, 2005). According to the TSBPA database, Ms. Grutzmacher's license was suspended in 2006 for alleged violation of mandatory CPE in the previous year. Ms. Grutzmacher practiced in the state of Texas after her suspension in 2006 until November 2008 when the Board elected to issue her a "3-year probated suspension of her license" due to numerous violations of GAAP in her involvement with the audit of Enron Corp (TSBPA, 2008). Ms. Grutzmacher's license has been expired since June 30, 2009 and, according to public record, she was issued another suspension in September 2009 for again failing to meet the requirements of CPE (TSBPA, P.S. Grutzmacher, n.d.). Ms. Grutzmacher's license has yet to be reinstated.

Michael M. Lowther was the partner in charge of Andersen's energy audit division in Houston, Texas and acted as a concurring review partner for Enron audits. The SEC found that Mr. Lowther ignored the signs that indicated the riskiness of Enron transactions. Furthermore, the commission found that he engaged in improper professional conduct and was thus charged with violation of Rule 102(e)(1)(ii) of the Commission's Rules of Practice. With this charge, the commission also denied Mr. Lowther the privilege of appearing or practicing before the SEC. However, after two years, he may apply for reinstatement to resume practice (SEC, 2008). According to the TSBPA database, Mr. Lowther's Texas CPA license expired on November 30, 2009 and is currently suspended for "discreditable acts" (TSPBA, M.M. Lowther, n.d.).

Michael C. Odom was the Practice Director at Arthur Andersen for the Gulf Coast Region (SEC, 2008). In an administrative hearing, the SEC stated that Mr. Odom, in his Director

position, was required to “oversee the resolution of client issues and the extent of their involvement was driven by the engagement team’s risk assessments” (SEC, 2008). In this case, Mr. Odom concurred with faulty risk assessments in regard to Enron audits. In doing so, the SEC found that Mr. Odom engaged in improper conduct as stated in Rule 102(e)(1)(ii). The rule states that a person may be denied appearance or practice before the Commission; Mr. Odom may request reinstatement after a two year period. According to the SEC, Mr. Odom is currently a registered CPA with the state of Louisiana and was registered during the relevant periods of said allegations (SEC, 2008).

Carl Bass was the engagement partner for the 1997 and 1998 JEDI Audit for Enron. The TSBPA filed a complaint against Mr. Bass for failure to follow auditing procedures, including not responding appropriately to audit risk facts that were determined, as well as not fully investigating relationships between Enron, CHEWCO, and JEDI. Furthermore, he did not properly supervise junior audit staff (TSBPA, 2005). The TSBPA reports that Mr. Bass currently has partner ownership in Arthur Anderson, LLP which began on September 1, 1994 and his license with the State of Texas has been revoked due to violations of “auditing standards, accounting principles, other professional standards, competence, and discreditable acts” (TSBPA, C.E. Bass, n.d.).

Thomas Bauer was the engagement partner for the ECT audit and also reviewed the JEDI Revolver agreement for Enron. He was responsible for complying with the AOP as well as GAAS and TSBPA rules. As a direct result of the revocation of Andersen’s firm license, the TSBPA filed a complaint against Mr. Bauer. The board alleged that he did not follow or supervise the following of proper audit steps. These steps would have demonstrated that some Special Purpose Entities or SPE’s (i.e. JEDI, CHEWCO) did not pass the three percent independence test for non-consolidation, thus not qualifying for off balance sheet treatment. Additionally, Mr. Bauer and his team relied upon Enron management assertions during their risk assessment without further investigating the assertions and failed to properly document audit steps taken for determination of the non-consolidation of the SPEs (TSBPA, 2005). According to the TSBPA, his license expired on October 31, 2008 (TSBPA, T.H. Bauer, n.d.). The U.S. Securities and Exchange Commission (SEC) reached a settlement with and Mr. Bauer is denied appearance or practice as an accountant before the SEC for three years. The commission determined that Mr. Bauer engaged in improper professional conduct thus violating Rule 102(e)(1)(ii) of the Commission’s Rules of Practice (SEC 2008). Mr. Bauer’s license has been revoked due to violations of GAAS in his involvement with the audits of Enron Corp (TSBPA, T.H. Bauer, n.d.).

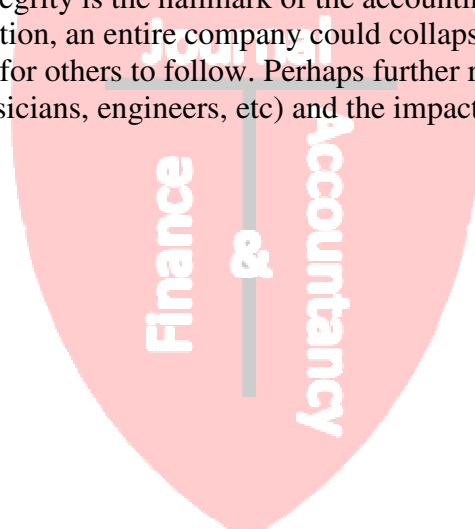
David Duncan was the Andersen global engagement partner for the Enron audits. Mr. Duncan was primarily responsible for the Enron audits. In 2002, a complaint was filed with the TSBPA citing violation of Auditing Standards. A resolution was reached that resulted in the revocation of Mr. Duncan’s license in the state of Texas (TSBPA, D.B. Duncan, n.d.). In addition, the SEC brought a civil action against him for his association with audits of Enron’s financial statements. He agreed to a settled injunction action. Mr. Duncan was charged with acting recklessly in issuing unqualified opinions on the 1998-2000 Enron audits, thus violating Section 10(b) and even further, Rule 10b- 5 of the Exchange Act. The SEC also stated that Mr. Duncan failed to exercise due professional care and skepticism. His responsibility included the creation, or supervision of the creation, of audit procedures that would assess risk in the Enron audit. Mr. Duncan failed to notify the Enron Audit Committee of the management’s rejection of audit recommendations. Mr. Duncan was “reckless in not knowing that Andersen’s audits of



Enron's financial statements were not performed in accordance with GAAS and that Enron's financial statements did not present Enron's financial position." By issuing unqualified opinions on the 1998-2000 Enron audits, he made material misstatements in the audit reports. He has not admitted nor denied the charges against him. However, he is permanently suspended from practicing, or appearing, as an accountant before the SEC (SEC, 2008).

Arthur Andersen's fall over the edge played out in the courtroom. The firm was found guilty of obstruction of justice by allegedly destroying documents that were vital to the SEC's investigation against Enron. On appeal, the case was overturned. However, the damage was already done; the firm lost the majority of its clients and most of its talented employees. Andersen's reputation was ruined. Three auditors from Arthur Andersen responsible for Enron audits lost their Texas CPA license. However, the fallout from the scandal contributed to major changes in the accounting profession and impacted all current and future CPA's.

Very few people were involved with the scandal at Arthur Andersen. However, thousands at the company lost their jobs. Enron collapsed, investors lost money, and confidence was eroded. Arguably, the accounting profession was changed and new regulations were enacted (i.e. Sarbanes Oxley Act). However, regulators were unable to punish many people in the Arthur Andersen and Enron case. Integrity is the hallmark of the accounting profession. If a few people lose sight of that simple assertion, an entire company could collapse. Managers must act with integrity and set the example for others to follow. Perhaps further research may explore other licensed professions (i.e. physicians, engineers, etc) and the impact of integrity lapses.



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