Why People Shouldn't Always Trust Their CPA. Between a Rock and a Hard Place. Ethics in Public Accounting! Part 3

May 2, 2016

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Some time ago, my brother-in-law Henry and I were discussing ethics in business and how things just seem to go wrong. Henry is a retired attorney, retired from a major law firm in Houston, Texas, and since I'm a CPA and he's a lawyer, and from Houston, we discussed a case dear to both our hearts, Enron. Enron is probably the grandaddy of all the examples of how accounting and auditing can go terribly wrong. And during the discussion, Henry said something that I know is true but it's hard to get my arms around it.

A little bit about Enron and what happened. Enron was probably the most reported accounting scandal in history. Millions of people lost money and many employees lost everything. The company paid bonuses in company stock which had been on an upward tear for quite some time. Then when the scandal broke, the company was out of business and those employees who had chosen to take bonuses, retirement match, etc. in company stock over cash lost everything, including their jobs.

> . . . it's still true that auditors may find something and may be forced to roll over. That's because, for many CPAs, as they move up the food chain in a CPA firm, they may lose sight of their mission, their original purpose in becoming a CPA.. . . There are other incentives now, incentives sometimes at odds with doing the "right thing".

How could something like this happen? Well, in a nutshell, Enron was run by unethical people, particularly the President and the CFO, but lots of others as well. Below is a very simplified, condensed description of one Enron "issue".

The CFO would put together a group of investors and form an entity, outside of Enron, to explore a site for oil and if oil was discovered, then they would drill and everyone was happy. But, the investors put up little, if any, risk money. All they had for their investment was a stock certificate. When they purchased the equipment needed for exploration, they purchased it not with cash but with long-term debt. And since the new company itself didn't have anything to guarantee the debt, since they were officers of Enron, they signed for Enron to guarantee the debt. If oil was discovered, no harm no foul. Enron wasn't harmed because Enron didn't have to perform on the debt. The outside company was in good shape because oil was discovered and thus, the company could service the debt for equipment. And the officers got rich because they owned the company even though they had put up no money at all. But what happened if oil WASN'T DISCOVERED? Then it was the opposite. Someone still had to service the long-term debt and since the outside company had no cash and Enron was the guarantor, Enron was on the hook. And this went on and on.

Some might wonder, "how is this an accounting scandal"? Well, here's a short lesson on one of the problems in the accounting profession and its relationship with its clients. If a client company comes to a CPA and tells the CPA they need an audit, the CPA will look over the previous audited financial statements, the management letters, call the predecessor CPA, and probably do a search on the principals just to be sure that none have been convicted of some financial or other crime that might come back to bite the CPA. And if everything seems OK, the CPA will write an arrangement letter and get started. But keep in mind who's paying the bill. It's the client. The client is paying the CPA to audit his financial statements and the bottom line is that he (the client) probably doesn't even want an audit. Someone else wants an audit! Who? Who might want an audit of that company's financial statements? Well, for starters, it could be the banker down the street where the client is trying to obtain a line of credit. Or it could be the bonding company where the client is trying to obtain bonding so he can bid on a large construction job. Or it could be any number of people who want to see the client's audited financial statements. But normally, you can be pretty sure the one person who doesn't want the audit, and certainly doesn't want to pay for the audit, is the client.

Arthur Andersen was the national firm who performed the audit of Enron's financial statements. Arthur Andersen began operations as a CPA firm in 1913 and by the time it closed its doors in 2002 it was one of the largest CPA firms in the world, one of the "Big 5". And they didn't just work in the accounting world. They had a large consultant group that operated semi-autonomously from the CPA group. The consultant group provided IT outsourcing, software development, and a myriad of other services. At Enron, the consultant group generated billings greater, much greater, than those generated by the CPA group. And that was the problem.

The CPA group questioned many of Enron's practices. They discussed it among themselves. They knew there were serious problems. But, there was too much money coming in to the firm from the consulting contracts. Many of the officers of the consultant group put pressure on the CPA group to "pass" on the problems. And, because of the fee pressures, they did exactly that. They "passed" on issues they knew they should not have. They knew better. They raised the bar for audit risk above what was prudent. And year after year, the CPA group issued an unqualified opinion on the financial statements as though nothing was wrong.

Why would they do it? They were professionals, among the best in the business. Why would they look the other way? Why would they let themselves be pressured into not trusting "their lying eyes"? Well, we go back to the discussion I had with my brother-in-law, Henry. Here's his scenario. Let's assume that you're a member of the CPA group, maybe a top level manager or partner. And let's assume that you know all the facts and you know that things are "not right". And let's further assume that you have a family, maybe a large mortgage, and maybe a child or two just about ready to start college. Now let's assume you receive a telephone call from three floors up, a call from one of the "higher ups" in the firm. And that someone wants to talk to you in his office. And the conversation goes something like this;

Higher up
"Joe, I understand you've determined and documented that there are problems with the way Enron is handling the offshore exploration in the companies owned by the CFO and President".

Joe
"Yes sir, that's true.

Higher up
"Joe, I understand you've been a senior manager for two years and you're on the partner track, moving right up, maybe ready to make partner next May."

Joe
"Yes sir, and yes it is my understanding that I'm next in line for partner".

Higher up
"And your new home in the Woodlands, how do you all like it out there"?

Joe
"We like it very much, sir. It's quiet and the schools are good".

Higher up
"Joe, do you know how much we, as a firm, billed Enron last year? Did you know that Enron is our second largest client? And did you know that the consultant group bills Enron about six times what the CPA side bills"?

Joe
"Yes sir, I know that".

Higher up
"Can you just imagine how many staff in this firm depend on billings from Enron"?

Joe
"Yes sir, I can imagine".

Higher up
"Joe, what would happen to you and your family if you lost your job"?

And so on. You can fill in the blanks. This is Henry's scenario but I'd bet it's not far from the truth. And the sad fact is, people all over Arthur Andersen, from top to bottom, rolled over and didn't say anything. Not a word. And the really sad fact is, this sort of thing happens all the time in the accounting world, maybe not of Enron's magnitude, but on a smaller scale. And even though we all know the rules have changed and we don't have the consulting and auditing issue to deal with, it's still true that auditors may find something and may be forced to roll over. That's because, for many CPAs, as they move up the food chain in a CPA firm, they may lose sight of their mission, their original purpose in becoming a CPA. They may tend to forget why companies have to have a financial statement audit. There are other incentives now, incentives sometimes at odds with doing the "right thing". Many "higher ups" seem to believe that the reason for the audit of the client's financial statements is so that they, the "higher up", usually a partner, can increase his billings and thus his status in the firm, in his own eyes, within his family, and, he believes, the community. Thus, many "higher ups" tend to take more and more risks. And above all, many "higher ups" will do anything, anything to obtain and/or keep a client. And often, they'll do it all in the name of *Client Service.*