

The Lessons of Enron

Alumni and faculty assess the legal and ethical issues surrounding the scandal

• BY MICHAEL J. McDERMOTT

Photographs by Tom Salyer

As the saga of Enron and its accounting firm, Arthur Andersen, LLP, continues to play out through the judiciary, regulatory agencies, legislative bodies and, ultimately, the court of public opinion, many lessons will undoubtedly be learned. Some are already apparent, and we spoke with a number of the School's alumni and faculty to get their take on what those lessons can teach us.

ONLY IN RETROSPECT WILL it become clear how extensive the fallout from Enron has been. As Lewis B. Freeman (BBA '71), a principal in Lewis B. Freeman & Partners, a forensic accounting and consulting firm in Miami, points out, the injury suffered by small investors potentially threatens the very foundation of equity trading markets.

"If you can't depend on what's being put out in the public offerings, then what can you trust? There are certain things in life that we depend on to be reliable, and in the investment world, required disclosures in financial statements were among those things," Freeman says.

The impact on small investors, espe-

cially those who had their retirement savings in Enron stock, has been well documented, but the shock wave continues to roll through American society and culture, triggering smaller crises that don't always hit the radar of the national media. William D. Pruitt (BBA '66), the UM Business School's Alumnus of Distinction in 1997, is well aware of that phenomenon. Pruitt retired from Andersen in 1999 after a 33-year career with the firm, where he served as the managing partner for Florida and the Caribbean. These days, he spends much of his time helping Andersen employees in South Florida try to salvage their careers — despite the fact that he stands to suffer personal financial loss should Andersen

cease to function as a business entity.

"There is no way to know what will happen until the court case is completed or a settlement is reached," Pruitt says. "If Andersen loses in court and has a criminal conviction, it can't survive, because it would be barred from practicing in front of the IRS. If it settles with the Justice Department, it will be a smaller firm, probably only an audit firm. At some point, it may merge with another firm, after it settles its liability with the Enron plaintiffs."

Even before the final chapter of the Enron saga has been written, troubling questions have been raised. Doubt has been cast on the relationships between accounting firms and the companies they are



Lewis B. Freeman
(BBA '71)



Charles C. Harper
(BBA '71)

supposed to audit, between investment advisors and the companies they are supposed to scrutinize, and between lawmakers and the companies they are supposed to regulate. Following are some of the major lessons that are emerging.

1. ETHICS – BOTH PERSONAL AND CORPORATE – MATTER.

Laurie Holtz, CPA (MBA '58), a director with the South Florida firm of Rachlin Cohen & Holtz, LLP, notes that the Report of the Special Investigation Committee of the Board of Directors of Enron Corporation (commonly referred to as the Powers Report) is filled with examples that appear to illustrate a disturbing lack of

ethics. One of the most troubling touches on the relationship between Enron and Andersen. Enron's accounting treatment of the now notorious "SPEs" (special purpose entities) that enriched some of its executives by tens of millions of dollars was "clearly wrong, apparently the result of mistakes either in structuring the transactions or in basic accounting," the Powers Report concludes.

In other cases, the accounting treatment was "likely wrong, notwithstanding creative efforts to circumvent accounting principles through the complex structuring of transactions that lacked fundamental economic substance," it continues. "In virtually all of the transactions, Enron's ac-

counting treatment was determined with extensive participation and structuring advice from Andersen." The report notes, in the same paragraph, that Andersen billed Enron \$5.7 million in connection with just two of those partnerships, "above and beyond its regular audit fees."

Enron throws the spotlight on an issue that has been raised before, although never with so high a profile. Critics like Holtz, who is known in industry circles as "the dean of forensic accounting," suggest that the major accounting firms face an inherent conflict of interest between their auditing divisions and their consulting business. "They use the audit business to get a foot in the door to sell the more profitable consulting services," he says. Andersen served as Enron's regular auditor, certifying its financial statements — a service for which it was paid \$25 million — and also as its internal auditor. It received \$23 million in consulting fees to advise Enron on its processes for bookkeeping and detecting fraud and irregularities.

In that kind of situation, "Someone's ethical compass sometimes gets broken," observes Charles C. Harper, (BBA '71), the former head of the U.S. Securities and Exchange Commission Enforcement Division in Miami and now with Lewis B. Freeman & Partners. "The people at Enron supposedly had a very close personal relationship with the auditors. That makes it hard to be independent."

Holtz feels the potential conflict of interest issues run even deeper. "There is something wrong with the profession generically when people go from working for an auditing firm to working for the company they were auditing, and that has been common practice in the accounting profession for a long time," he says. A common career path for accountants who don't make partner at their firm is to take a job at one of its clients. Often, a member of the accounting firm's audit team is moved up to fill the vacancy and is faced with having to go to a former boss — perhaps even a mentor — when irregularities are found. "If that person tells him, 'No, don't



Laurie Holtz
(MBA '58)

worry about it, it's OK,' then what is he going to do?" Holtz asks.

Of course, no matter what Andersen's role in the collapse of Enron turns out to be, all the blame for the resulting damage cannot be laid at the feet of the accounting profession. As the Powers Report notes, "the primary responsibility for financial re-

porting abuses ... lies with management."

"At some point, they had to know there was wrong being done. At some point, they decided they could use their power, money and prestige to hoodwink the world," Freeman says. "Let's face it, if you don't have management who make the books look funny, there isn't going to be anything for the auditors to

find in the first place. From what's come to light so far, it looks like Enron had a feeding frenzy."

As Anita Cava, Associate Professor of Business Law and Co-Director of UM's Ethics Programs, notes, "There is a huge breakdown (in morals and ethics) at all levels going on here." (See story, page 21.)

2. FINANCIAL FIRMS CANNOT SERVE TWO MASTERS.

What about Wall Street's role in all of this? That's a question being raised with increasing frequency, and not just in relation to Enron. Things have changed on Wall Street in the Information Age. Individual investors now have access to most of the same information as investment professionals, and almost as fast. Online trading firms and discount brokers have made it cheaper for investors to buy and sell stocks.

Those changes have cut deeply into the commissions stock brokers used to earn. Twenty years ago, Wall Street firms hired stock analysts to scrutinize companies' financial statements, learn the fundamentals of the businesses in which they were engaged and issue buy and sell recommendations based on their findings. With the revenue stream from commissions drying up, today's analysts are more commonly rewarded for helping to steer

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A View from the Inside

Raymond P.H. "Pat" Fishe, Professor of Economics, spent the 1999-2000 year as a Visiting Academic Fellow at the Securities and Exchange Commission. We asked him about the SEC's role in the Enron saga.

Does Enron illustrate any ways in which the SEC or its processes needs to be changed?

The SEC, like Wall Street, reviews Enron's public filings to determine if they comply with all applicable laws. If the courts decide that Enron hid "material information," then the SEC bears part of the blame. To adjust to Enron, the SEC will likely revamp its Division of Corporate Finance. I suspect that the filing review process will take longer as more people will need to concur that a company has not left out anything that is important. The SEC creation of a new oversight board for accountants is another adjustment, but to me, this does not look very significant.

What questions does Enron raise about shortcomings in the interactions between the SEC and the involved parties?

The basic ethical issue is how executives deal with SEC disclosure rules: Do they fully comply, or do they try to find ways around these rules? A secondary issue is whether executives should be allowed to trade for their personal accounts at the same time they present an opposing "corporate" line to employees. The rating agencies, underwriters and analysts, including SEC staff, failed to realize the sizable risk in Enron's total positions. Those positions moved against them when energy prices reversed course.

Who is at fault and who were the injured parties in this story?

The courts will decide that, but most likely they will include a few partners at Arthur Andersen and the top executives at Enron. The Enron



board also looks to be at fault, particularly after they relaxed the company's conflict of interest rules. Investors both inside and outside the company are the obvious victims....On another level, the accounting profession is looking rather silly.

What changes will result from Enron, and how can similar situations be avoided?

There is likely to be new regulation of corporate disclosure, including more civil and criminal penalties. But no matter what steps are taken, there will always be future Enrons. —M.J.McD.

Making the Right Decisions

investment banking business to the firm. "How often have you seen an analyst come out with a sell signal?" asks Harper. "Their bonuses are tied to the investment banking business, and you don't win those clients by advising investors to sell their stock. It's a horrible situation, and it's the same thing that drove the tech bubble."

Earlier this year, New York Attorney General Eliot Spitzer announced that he was going after the giant Wall Street firms to protect small investors who might not be aware of the funding dynamic that now drives the investment business. In April, the SEC signaled it was launching its own broad inquiry to determine if any laws have been violated and if new rules need to be written to deter conflicts of interest among stock analysts.

Paul Munter, KPMG Professor and Chair of Accounting, sees Wall Street contributing to the Enron debacle in another, albeit indirect, way. "The investment community has to bear some responsibility because of the demands placed on companies over the past five to 10 years to meet earnings targets," he points out. "There is too much of a short-term focus on Wall Street." Ultimately, though, he acknowledges, the responsibility falls on Enron's executives and its auditors.

To be sure, the deals and accounting schemes that led to Enron's downfall were extremely complex, and it is entirely possible — perhaps even likely — that many of the analysts who covered the company and recommended its stock did not fully understand what was going on. Even the experts were fooled, at least for a while. Standard & Poor's affirmed a BBB+ (investment grade) rating for Enron's debt on October 16, after the company announced \$2 billion in write-downs. At the time, S&P said it expected Enron's balance sheet to recover. Six weeks later, it lowered its rating to junk bond levels and acknowledged that bankruptcy was a distinct possibility for Enron.

It's tempting to look at Enron as a proxy for all that is wrong with the U.S. free enterprise system, but is that a fair assessment? Anita Cava, Associate Professor of Business Law and Co-Director of UM's Ethics Programs, has been using the scandal to prompt her students to think about the ethical and moral issues involved, as well as the legal ones.

What are the big ethical and moral questions raised by Enron?

There is a huge breakdown at all levels going on here. It reminds me of Tom Wolfe's book, *The Bonfire of the Vanities*, where the main characters' view of themselves and their world becomes so distorted they start believing that what they are doing is not only "good," it should not be subject to scrutiny or review....Quite clearly there were significant ethical lapses in the decision-making at every level — government, lobbyists, the executives who lined their own pockets, Wall Street.

From the perspective of moral and ethical accountability, what needs to be done to prevent this from happening again?

I've posed this question to my students, and they have responded overwhelmingly that more regulations are required. But there will never be a rule for every question one faces. The essence of ethical decision-making is to make the choice that serves the general good. The perspective of many of my students is that that



kind of thinking is not going to happen in the current environment. Others suggest more optimistically that there needs to be more attention paid to ethics education at every level, starting in grammar school.

What responsibilities do business schools have in this regard?

Business schools have an obligation to teach critical thinking and challenge students to understand that business is not just about making all the money you possibly can. It's also about making good decisions that promote the virtues of integrity, respect, loyalty and professionalism. At the end of the day, those are ethical virtues.

— M.J.McD.

3. OUR WATCHDOGS LACK TEETH.

Holtz's feeling is that the problems laid bare by Enron run deep and broad, and that singling out just one or two sectors for blame makes little sense. As he puts it, "The Enron fiasco is a culture thing, not just a bad audit. There is a certain arrogance of power that occurs. When you get enough power, you think you can do any-

thing, and you can. The power of the people involved in Enron — from Wall Street to Washington, D.C. — is amazing."

When considering the Enron debacle, it's important to focus on who was "feeding at the trough," Holtz points out. Giant banking firms, the nation's largest retirement fund (CalPERS, which *The New York Times* has described as "the watchdog that did not bark"), stock analysts whose firms pocketed huge fees, politicians who accepted massive

campaign donations — all played some role in what happened and bear some responsibility for the fallout, he says.

"When you can pick up the phone and say you can put up \$100 million for a special entity partnership, that's power, and you start to believe what you tell other people," Holtz says. "Did they care about the morality? Did they delve into the deeper issues? They were all making

exorbitant fees paid to lobbyists who were able to deflect serious scrutiny and, of course, campaign contributions — these are all issues that all need to be closely examined. The bottom line is that accountability is required, and accountability requires an informed citizenry."

There is also a natural tendency to ask whether the SEC bears any of the blame for Enron. "It would be nice to pin the

blame on some government agency, but the people at the SEC are dedicated and hard-working, and they are doing the best job they can with the resources they are given," says Harper. Adds Freeman, "You have to look at how much the securities markets have changed since the time the SEC was formed. Has the SEC been given the budget and tools to keep up with those changes? The answer is no."

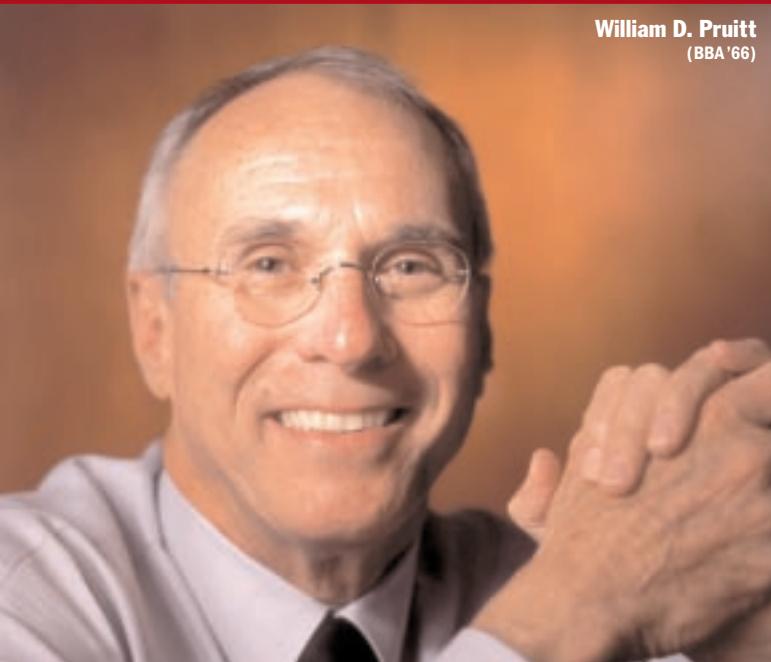
article point out, U.S. markets are the envy of the world, and they rely on the free flow of information — and investor confidence in the validity of that information — to function efficiently. If that trust is lost, the markets could be hurt. Already, companies have seen their stocks take a hit because of questions about accounting practices. Other firms have scrambled to improve disclosure and provide more detail about off-balance-sheet entities and loan write-offs. Over the long term, though, such improved transparency should be a plus for the market, Holtz predicts.

5 THE STORY ISN'T OVER, AND HEROES WILL EMERGE.

Finally, there is the direct impact the fallout from Enron and Andersen has had on the lives of ordinary people who try to continue making a living at those firms, as well as those who had dreams of retiring from them. As so often seems to be the case with stories like Enron, this is where the first positive developments begin to appear, thanks to people like Bill Pruitt.

While Pruitt's own financial future, even his health care coverage, is potentially threatened by the outcome of any action against Andersen, he is most concerned about those who still work there. "It hasn't affected me the way it has affected them," he insists. Taking time from his own consulting business, Pruitt has worked with Jesus Diaz, office managing partner with cross-town rival Ernst & Young, to put together a deal that would bring all Andersen's employees and clients over to that firm should Andersen fold. As a result, while Andersen clients are defecting in droves across the country, the firm has lost just a single audit client in South Florida.

Pruitt and Diaz began their discussions at a chance meeting at a Chamber of Commerce dinner honoring UM Life Trustee Leonard Miller and his wife, Sue. If there is a "hero" in this localized subplot to the larger Enron saga, it is Diaz, not himself, Pruitt insists. But in a disturbing business tale that can use all the heroes it can get, it's safe to say both Pruitt and Diaz fit the bill. ■



William D. Pruitt
(BBA '66)

money. This is not a lot different from giving that guy the fifth drink at the bar. All of our establishment was feeding at the trough one way or another. They almost felt entitled to it."

There is the issue of those who should have been monitoring Enron, in theory, to prevent just the kinds of abuses that took place. In retrospect, all appear to have fallen short. Charges and about who influenced whom have been flying back forth, and no doubt that will continue.

"I am very concerned by the suggestion that Enron executives were able to tinker with legislators to make what they did legal. It has the appearance of buying legislation, and that is a real problem," Cava says. "The ability of those formerly in government to influence their colleagues, evidence of discretionary enforcement,

4 ENRON WILL HAVE LONG-RANGING REPERCUSSIONS.

Much of the fallout from Enron's collapse has been well documented, particularly the devastating effect it has had on the savings and retirement funds of many small investors. Other effects have also been material, if less widely publicized. For example, the insurance industry faces Enron-related losses of about \$3.5 billion. Coupled with losses resulting from the September 11 terrorist attacks, the result promises to be insurance rate increases across the board. "We may not be able to identify some of the economic impacts of Enron until well after they've happened," suggests Munter.

One unknown is Enron's ultimate impact on the securities markets. As Freeman and several others interviewed for this

Enron in the Classroom

There is a saying in the public relations business that there is no such thing as bad publicity. That said, the Enron debacle certainly has put a new focus on the accounting profession. While much of the publicity so far has been less than flattering, accounting will play an important role in the events to follow as the courts and regulatory agencies work to sort out the facts.

"I think Enron is raising the profile of accounting in business schools," says Paul Munter, KPMG Professor and Chair of Accounting. "This case is bringing a lot of visibility to accounting and auditing, and I think interest levels will increase. We are already seeing signs of that, with more students from non-accounting majors signing up for accounting courses. That's a big change. I think people are starting to realize that it's important for all parties to financial transactions and investments, especially complicated ones, to understand the accounting principles involved."

One area of the accounting profession where Enron has definitely raised awareness is auditing, says Kay W. Tatum, Associate Professor of Accounting. "Enron has created an awareness of the internal audit, external audit and audit committee processes, as well as the economic consequences when they fail," she notes. "I will be teaching a group of executive MBAs from the Netherlands at the University of Miami this summer. In addition to topics about strategy and quality management, they have requested a segment about recent events in corporate governance in the United States, including the implications of Enron."

Enron is also prompting accounting educators to take a closer look at how they teach the subject, Munter says. Some in the academic community have been arguing for a broader educational approach with less technical focus in recent years, but he believes the lessons of Enron suggest another route.

"We have to return to core values and ethics. We have become so wedded to the letter of accounting standards, but we have to look at whether this really tells us what a company is about," he says. "Students do need to understand the structure of businesses and business transactions to make reasoned evaluations of accounting, but we need to refocus on the core val-



ues of ethics and professionalism in the accounting profession."

Both Munter and Tatum say that Enron has not changed the way they teach students, but that it has created opportunities to enliven their curriculum. Enron has provided vivid anecdotes for Tatum's undergraduate auditing class and an excellent case study for "Fraud Prevention and Detection," a graduate course she team-teaches with Lawrence C. Phillips, Professor of Accounting and Deloitte & Touche Scholar in Accounting. "After Enron, I am convinced that any business major who aspires to be a CEO, CFO, a board member and/or an auditor needs a basic understanding of financial accounting, auditing, internal control and the audit committee's role in overseeing those processes," she says.

Munter speaks of the responsibility seasoned members of the accounting profession have to mentor novices and to embed the ethics of professionalism in students. "There needs to be a top-down approach, drilling down to the details later but starting at the top with the big picture," he suggests. "This is already happening. We are making it a point to do that, and students are more receptive now." — M.J.McD.



KAY W. TATUM

ASSOCIATE PROFESSOR OF ACCOUNTING