The Role of The Forensic Accountant in Assessing The Control Environment and Anti-Fraud Programs and Controls

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1.0 INTRODUCTION

1.1 Background

A series of highly publicized business failures resulting from corporate frauds, starting with Enron, led to the introduction of the Sarbanes Oxley Act of 2002 ("SOX" or the "Act"). The implications of such corporate failures included losses to shareholders and the resulting loss of investor confidence in the capital market, loss of pension benefits to employees, and losses to vendors, service providers, customers and other business partners. The Act was introduced to protect investors by improving the reliability of financial reporting in an effort to restore investor confidence in the capital market. The Act, among other things, requires that management assess the effectiveness of internal controls over financial reporting. It also requires that the independent auditor attest to, and report on, management's assessment of internal controls.

One implication of SOX on the accounting profession is that auditors of public companies are now required to issue three opinions; an opinion on whether the financial statements are fairly presented, an opinion on management's assessments of internal controls over financial reporting, and their own assessment as to the effectiveness of internal controls over financial reporting.

The rules imposed on the accounting profession by the Public Company Accounting Oversight Board (the "PCAOB")[1] require the independent auditor to assess the effectiveness of the internal controls over financial reporting using a recognized

[1] The PCAOB is a not-for-profit corporation established by SOX to oversee the audit of public companies.

framework, such as the Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commissions (the "COSO Framework" or "COSO"). The PCAOB also released Auditing Standard No. 2 which defines internal controls over financial reporting, sets out the auditor's objectives in auditing internal controls over financial reporting and sets out management's responsibilities in the audit of internal controls over financial reporting. Auditing Standard No. 2 emphasizes the importance of the Control Environment[2] and Anti-Fraud Programs and Controls[3] in assessing internal controls over financial reporting. The purpose of this paper is to examine the role of the forensic accountant in assessing the Control Environment and Anti-Fraud Programs and Controls.

1.2 Structure of This Paper

This paper will summarize the key components of SOX and PCAOB Auditing Standard No. 2, as they relate to the Control Environment and Anti-Fraud Programs and Controls in Section 3 and will provide an overview of the COSO Framework in Section 4. Section 5 of this paper will describe the Control Environment factors and will present a case study analysis by applying the COSO Framework in assessing the Control Environment of Enron.

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[2] COSO describes the Control Environment as one aspect of company level controls that is the foundation for all other components of internal control. It sets the tone of the organization with respect to ethics, integrity and control-consciousness.

[3] Anti-Fraud Programs and Controls are controls designed by management to prevent fraud or reduce the likelihood of fraud occurring to an acceptable level, to detect and investigate fraud when it does occur and to outline appropriate remedial actions.

For each Control Environment factor set out in Section 5, this paper will first explain the characteristics that one would expect to see in a strong Control Environment, as set out in the COSO Framework. It will then describe the Control Environment characteristics of Enron, as depicted in the book *Power Failure: The Inside Story of the Collapse of Enron*[4] ("*Power Failure*"). Section 5.8 of this paper provides comments and observations with respect to the Control Environment weaknesses that contributed to or allowed the fraudulent activities at Enron to go undetected. It also relates those Control Environment weaknesses to common red flags of fraud, which were abundant at Enron. The paper concludes, in section 6, with a discussion the role of the forensic accountant in assessing the Control Environment and Anti-Fraud Programs and Controls.

[4] Mimi Swartz with Sherron Watkins, *Power Failure: "The Inside Story of the Collapse of Enron",* First ed. (Doubleday: March 2003).

2.0 EXECUTIVE SUMMARY

SOX and the PCAOB have recognized the importance of the assessment of the Control Environment and Anti-Fraud Programs and Controls to the overall assessment of internal controls over financial reporting. Despite its importance, my experience in performing company level control reviews, including Control Environment assessments, and advising clients on Anti-Fraud Programs and Controls, has led me to conclude that the Control Environment is one of the areas of the internal control assessment that receives the least attention and resources from both management and the independent auditors. It appears that this situation is due to both a lack of understanding of the importance of the Control Environment and uncertainty as to how to perform an effective Control Environment assessment both within the accounting profession and in public corporations. Furthermore, many public companies seem to be focusing on Anti-Fraud Programs and Controls at the process level with no consideration of the high-level controls such as "tone at the top", culture, incentive compensation and attitude toward management override.

An evaluation of the Control Environment using the COSO Framework includes an evaluation soft controls such as "tone at the top" and management attitude toward financial reporting and internal controls. It is important to recognize that the COSO Framework stemmed from the report of the National Commission on Fraudulent Financial Reporting prepared by the Treadway Commission and therefore has its foundation in fraud prevention and detection. Forensic accountants are specifically trained and very experienced at recognizing red flags of fraud and environmental

factors which contribute to fraud, as well as having an in-depth understanding of fraud prevention and detection controls. Furthermore, forensic accountants are experienced in performing fraud risk assessments, which include an evaluation of the soft controls such as "tone at the top", culture, ethics, communications and reward management. Therefore, although forensic accountants may not have specific experience in applying the COSO Framework, the approach and concepts are very familiar to them. This is not surprising since the origin of COSO can be traced back to concerns over corporate fraud in America.

A review of the internal control deficiencies reported by public companies indicates that, despite the continued reporting of corporate fraud in the marketplace, very few public companies are disclosing weaknesses in the Control Environment. An article presented in the May 10, 2005 edition of Compliance Week[5] which analyzed the 93 material weakness disclosures made by public companies in April 2005, indicated that only 2.15% of reported deficiencies related to Control Environment and 1.08% related to Anti-Fraud Programs and Controls. Furthermore, the author's review of all material weakness disclosures reported by public companies for the period January 1, 2004 to December 31, 2004, indicated that only 11 of the 582 material weaknesses disclosures (i.e. 1.9%) specifically addressed the Control Environment. And yet, the daily newspapers are full of stories of fraud and misconduct, identifying companies with apparent Control Environment issues the stem from poor "tone at the top". Consider the following examples:

[5] Compliance Week is a newsletter on corporate governance and compliance issues, prepared by an independent publisher, see www.complianceweek.com.

- On March 16, 2005 the Chicago Tribune reported that a civil lawsuit had been filed following an SEC investigation, which alleged that nine former employees of Qwest Communications International Inc. orchestrated a scheme to artificially inflate revenues by $3 billion between 1999 and 2001. Included among the accused is Chief Executive Officer, Joseph Nacchio. The Chicago Tribune reports that *"The SEC's complaint alleged that Nacchio created a culture in which meeting earnings expectations was paramount, causing a 'culture of fear' as pressure mounted to post acceptable results 'at all costs'."*[6];

- On April 11, 2005 an article in Arkansas Business reported that Wal-Mart fired the Director of Operations and a Senior Vice President for *"violating established company rules"*[7]. This occurred not even a month after Coughlin, the second in command after the CEO, resigned on March 25 under pressure from the board following an *"investigation into alleged unauthorized use of corporate-owned gift cards and reimbursements obtained with false information"*[8] valued between $100,000 and $500,000; and

[6] Andrew Countryman, *Ex-CEO of Qwest accused of fraud*, The Chicago Tribune: March 16, 2005, Pg. 1.
[7] Bill Bowden, *Two fired Wal-mart executives named in Texas Probe,* Arkansas Business: April 11, 2005, Vol. 22, No. 14, Pg. 1.
[8] Bowden 1.

- On April 19, 2005 the Associated Press reported that Gregory S. Horton, one of America Online's most senior executives, was sentenced to nearly four years in prison for *"defrauding the company . . . [via] a scheme in which he allowed himself to profit from a sham consulting contract"*[9]. Interestingly, the Associated Press reports that while the court records show that Horton defrauded AOL of only $100,000, he also admitted to having defrauded two previous employers of more than $2 million using similar schemes.

The above articles demonstrate a fact well-known to experienced forensic accountants; major corporate frauds can invariably be traced back to senior people with the organization and, ultimately, to weaknesses in the Control Environment.

Based on these observations, it appears that training and education are necessary to get both the independent auditors and public companies up the learning curve with respect to the assessment of the Control Environment and Anti-Fraud Programs and Controls if SOX 404 is to meet its objective of improving the reliability of financial reporting. Because of their unique experience in the area of fraud risk assessments, forensic accountants are uniquely positioned to provide assistance to both the independent auditor and public companies in developing and implementing an approach to assessing the Control Environment and Anti-Fraud Programs and Controls. Despite the natural alignment of the forensic accountant's skill set to the assessment of the Control Environment and Anti-Fraud Programs and Controls, the inclusion of forensic

[9] Matthew Barakat, *Former AOL executive sentenced to four years in prison for defrauding company,* The Associated Press: April 19, 2005

accountants on the audit team and/or management's SOX advisory teams appears to be quite limited. In fact, it remains to be seen whether or not the forensic accounting profession as a whole will recognize and embrace this opportunity. It is the view of the author that inclusion of forensic accountants on management's SOX advisory team and on the independent auditor's integrated audit teams would significantly improve the quality of Control Environment assessments and thereby increase reliability of financial reporting.

3.0 THE GOVERNMENT RESPONSE TO CORPORATE FAILURES

While the need for corporate governance reform in the US had long been recognized[10] by the accounting profession, Congress and the SEC, the process of reform seemed to be stalled. Then, a series of corporate scandals that started with Enron in 2001, and included others such as WorldCom and Tyco, provided the impetus for change that led to the introduction of SOX.

3.1 The Sarbanes-Oxley Act of 2002

The stated intention of SOX is *"[t]o protect investors by improving the accuracy and reliability of corporate disclosure made pursuant to the securities laws, and for other purposes."*[11] The Act has implications for not only U.S. public companies and foreign public companies that are traded in the U.S., but also for regulators, public accountants, audit committees, lawyers, corporate executives and analysts. The Act is comprised of eleven titles, which are summarized in Appendix B to this paper to provide the reader with an understanding of the breadth of SOX and to highlight measures taken to improve the reliability of financial reporting. Those titles that are particularly relevant to this paper, because they have implications for internal controls over financial reporting, are addressed in the sections that follow.

[10] See Appendix A for a summary of corporate governance reform initiatives, as summarized from a letter dated April 12, 2005 prepared by Glass Lewis & Co. to the Securities Exchange Commission (the "SEC") in response to the SEC's request for comments for the April 13, 2005 Roundtable on Implementation of Sarbanes-Oxley Internal Control Provisions.

[11] The Sarbanes-Oxley Act of 2002. H.R. 3763

3.1.1 Section 404

Section 404 requires that each annual report *"contain an internal control report, which shall –*

1) *state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and*
2) *contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting."*[12]

In addition, the public accountant that prepares the audit report is required under section 404 to attest to, and report on, management's assessment of internal controls. It is Section 404 that results in the requirement for both management and the independent auditor, among other things, to assess the Control Environment and Anti-Fraud Programs and Controls. Clearly assigning this responsibility to management and holding them accountable for the internal controls over financial reporting can play an important role in fraud prevention and detection by raising the control consciousness of the organization.

3.1.2 Section 302

Section 302 addresses corporate responsibility for financial reports. It requires principal executive officers (i.e. CEO and CFO) to evaluate the effectiveness of internal controls over financial reporting. Section 302 is particularly important because it places new responsibility on the CEO and CFO to certify in the annual or quarterly

[12] Sarbanes – Oxley Act of 2002 H.R. 3763-45

report, indicating that that they have reviewed the report and that it *"does not contain any untrue statement of a material fact or omit to state a material fact necessary"*[13] and that *"based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report"*[14].

Section 302 further requires that the principal executive officers acknowledge in the certification that:

- they are responsible for establishing and maintaining internal controls;
- they have designed such internal controls to ensure that material information is made available to them;
- they have evaluated the effectiveness of the internal controls and reported thereon;
- they have disclosed to the auditors and audit committee all significant deficiencies and any fraud involving management or employees with significant internal control functions; and
- there were no significant changes in internal controls.

Section 302 is important because it clearly places the responsibility for establishing and maintaining internal controls over financial reporting with the officers of the company. In addition to the benefit of disclosing material weaknesses in the internal controls over

[13] Sarbanes – Oxley Act of 2002 H.R. 3763-33

[14] Sarbanes – Oxley Act of 2002 H.R. 3763-33

financial reporting, this section may result in increased awareness on the part of senior management with respect to "tone at the top " and the control-consciousness of the organization, both of which are important aspects of Control Environment, and Anti-Fraud Programs and Controls.

3.1.3 Section 301

Section 301 of the Act sets out specific measures with respect to Audit Committee responsibilities. The most significant measure in relation to the Control Environment and Anti-Fraud Programs and Controls is the requirement that the Audit Committee to establish procedures for *"the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters"*[15] and *"the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."*[16] These requirements are particularly important to Anti-Fraud Programs and Controls as they provide a formal reporting mechanism that is structured in a way to promote the reporting of suspected improprieties. The reporting of suspected improprieties is critical to fraud prevention and detection, as demonstrated by KPMG's 1999 Fraud Survey Report (see Appendix C), which indicates that 37% of known frauds were discovered as the result of "whistle-blowers". Only internal controls, at 55%, were cited as being responsible for identifying a greater proportion of the known frauds.

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[15] Sarbanes – Oxley Act of 2002 H.R. 3763-32

[16] Sarbanes – Oxley Act of 2002 H.R. 3763-32

3.1.4 Section 806

Section 806 provides whistle-blower protection by making it illegal for an issuer or officer, employee, contractor or agent thereof, to *"discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee –*

1) *To provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by –*
    a) *A Federal regulatory or law enforcement agency;*
    b) *Any Member of Congress or any committee of Congress; or*
    c) *A person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or*
2) *To file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of the Federal law relating to fraud against shareholders."*[17]

[17] Sarbanes – Oxley Act of 2002 H.R. 3763-59

The remedies set out in Section 806 are designed to *"make the employee whole"*[18] and include compensatory damages such as reinstatement and back pay with interest and compensation for special damages including litigation costs, expert witness fees and attorney fees. Protection of whistle-blowers is critical because, as indicated above, anonymous tips are responsible for identifying a significant portion of detected frauds.

3.1.5 Conclusion

The sections of SOX that are discussed above put into legislation various measures that can have a profound effect on the prevention and detection of fraud. The requirement to establish a whistle-blower mechanism, along with the protection provided by the Act for whistle-blowers increases the likelihood that fraud and misconduct will be reported. The emphasis placed on the role of the company's officers in establishing and maintaining the internal controls over financial reporting gives them responsibility and accountability for establishing a culture of control-consciousness. In addition, a new emphasis is placed on fraud risk awareness and fraud prevention and detection controls.

It should be noted that since the Canadian rules, which are in the process of being finalized, are very similar to SOX and because implementation guidance at this point in time is limited primarily to SOX, the remainder of this paper will discuss the Control Environment and Anti-Fraud Programs and Controls in relation to SOX and the PCAOB requirements rather than their Canadian equivalents.

[18] Sarbanes – Oxley Act of 2002 H.R. 3763-59

3.2 The Public Company Accountability Oversight Board (PCAOB)

The PCAOB was established by SOX and is a private-sector, non-profit, corporation comprised of five appointed members, no more than two of which are or have been certified public accountants. The mission statement of the PCAOB is *"to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports"*[19].

The PCAOB was authorized by SOX to establish auditing and related professional practice standards applicable to all public accounting firms registered with the PCAOB (i.e. essentially all public accounting firms that audit public companies whose shares are traded in the U.S.). As described in the PCAOB Release No. 2004-01 ("Release No. 2004-01"), SOX and the PCAOB were introduced solely as a result of business failures related to corporate fraud. Release No. 2004-01 states that:

> *"The series of business failures that began with Enron in late 2001 exposed serious weaknesses in the system of checks and balances that were intended to protect the interests of shareholders, pension beneficiaries and employees of public companies – and to protect the confidence of the American public in the stability and fairness of the U.S. capital markets.*

[19] Public Company Accounting Oversight Board, http://www.pcaob.org; accessed April 22, 2005.

From the boardroom to the executive suite, to the offices of the accountants and lawyers, the historic gatekeepers of this confidence were found missing or, worse, complicit in the breaches of public trust.

Congress responded to the corporate failures with the Sarbanes-Oxley Act of 2002, creating a broad, new oversight regime for auditors of public companies while prescribing specific steps, to address specific failures and codifying the responsibilities of corporate executives, corporate directors, lawyers and accountants.

The merits, benefits, cost and wisdom of each of the prescriptions can and will fuel debate. But the context for the passage of the Sarbanes-Oxley Act, and the President's signing it into law on July 30, 2002, cannot be ignored: Corporate leaders and advisor's failed. People lost their livelihoods and their life savings. The faith of Americans and the world in U.S. markets was shaken to the core."[20]

In order to address what Release No. 2004-10 describes as the failure of the auditors in their role as "gatekeepers of confidence", the PCAOB developed rules relating to the registration and reporting of public accounting firms, professional standards, inspections, investigations and adjudications. The PCAOB issued a number of Auditing Standards, however, given that the subject of this paper is Control Environment and Anti-Fraud Programs and Controls, it will focus on summarizing and

[20] Public Company Accounting Oversight Board, *PCAOB Release 2004-01*; March 9, 2004.

interpreting PCAOB Auditing Standard No. 2 as it relates to company level controls, including Control Environment and Anti-Fraud Programs and Controls.

3.2.1 PCAOB Auditing Standard No. 2

Generally, PCAOB Auditing Standard No. 2 - An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements ("Auditing Standard No. 2"), sets out the standards with which auditors must comply in auditing internal controls over financial reporting. As described above, Release 2004-01 makes it very clear that Auditing Standard No. 2 was developed in response to corporate fraud and the standard itself emphasizes the importance of the Anti-Fraud Programs and Controls and the company level controls, including the Control Environment.

In general, Auditing Standard No 2. sets out the following requirements for the auditor:

- To express an opinion on management's assessment of the effectiveness of internal controls over financial reporting;
- To obtain reasonable assurance as to the effectiveness of internal controls over financial reporting at the date specified in management's assessment; and
- To audit the company's financial statements.

Auditing Standard No. 2 defines internal controls over financial reporting and provides guidance with respect to management's responsibilities in conducting its assessment thereof. Specifically, paragraph 7 defines internal controls over financial reporting as:

> *"A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:*
>
> 1) *Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;*
> 2) *Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and*
> 3) *Provide reasonable assurance regarding prevention or timely detection of authorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements."*[21]

[21] Public Company Accounting Oversight Board A-7

In addition, there are a number of paragraphs in Auditing Standard No. 2 that emphasize the importance of company level controls and Anti-Fraud Programs and Controls, which are of particular relevance to this paper. In particular, the following paragraphs address the PCAOB's views on the Control Environment and Anti-Fraud Programs and Controls:

- Paragraph 24 recognizes the pervasiveness of controls related to fraud prevention and detection and requires that the auditor evaluate all controls *"specifically intended to address the risks of fraud that have at least a reasonably possible likelihood of having a material effect on the company's financial statements"*[22], which includes both control activities and company level controls. The PCAOB identifies controls over misappropriation of assets, the risk assessment process, the code of ethics, the internal audit function and reporting mechanism for complaints relating to questionable accounting or auditing matters as key fraud prevention/detection controls. However, Auditing Standard No. 2 also emphasizes that this list is not all-inclusive;

- Paragraph 25 sets out a number of factors which, in the view of the PCAOB, significantly reduce the opportunity to commit fraud, including setting the proper tone, maintaining a culture of honesty and high ethical standards, and establishing controls to prevent, deter and detect fraud;

[22] Public Company Accounting Oversight Board A-15

- Paragraph 40 addresses how to determine which controls should be tested in auditing the internal controls over financial reporting. Among the controls that should generally be tested are Anti-Fraud Programs and Controls and company level controls, including the Control Environment;

- Paragraph 49 specifies that the auditor must obtain an understanding of each component of internal control over financial reporting. The components listed, which are consistent with the components set out by the COSO Framework, are Control Environment, Risk Assessment, Information and Communication, Monitoring and Control Activities. All of these control components are company level controls except for Control Activities. An overview of these components of internal control will be addressed in section 5.0 of this paper;

- Paragraph 52 addresses the pervasiveness of company level controls and their impact on controls at the activity level, and suggests that consideration should be given to evaluating company level controls before activity level controls;

- With respect to testing, paragraph 105 indicates that the importance of the controls should be considered in determining the appropriate scope of testing. It states that controls that address multiple financial statement assertions would be considered more important. Although the PCAOB does

not specifically refer to testing of the company level controls, it does recognize throughout Auditing Standard No. 2 the pervasiveness of such controls. Accordingly, the author concludes that the company level controls, including Control Environment, should receive special focus in testing;

- Paragraph 139 states that deficiencies related to Anti-Fraud Programs and Controls are at least a significant deficiency; and

- Paragraph 140 states that identification of fraud of any magnitude on the part of senior management is at least a significant deficiency and a strong indicator of a material weakness.

With an understanding of the events the led to the introduction of SOX, an understanding of the Act itself and an understanding of the PCAOB's views on Anti-Fraud Programs and Controls and Control Environment, it is clear that the prevention and detection of fraudulent financial reporting is a key objective of SOX. Accordingly, it stands to reason the forensic accountants, as experts in the field of fraud prevention and detection have a role to play with respect to SOX.

3.2.2 Identification of Internal Control Deficiencies

The following paragraphs describe what constitutes a reportable internal control deficiency under Auditing Standard No. 2 in order to provide the reader with a context for understanding the significance of Control Environment weaknesses and deficiencies in Anti-Fraud Program and Controls. Auditing Standard No. 2 states that *"[m]anagement is precluded from concluding that the company's internal control over financial reporting is effective if there are one or more material weaknesses. In addition, management is required to disclose all material weaknesses that exist as of the end of the most recent fiscal year."*[23] Furthermore, Auditing Standard No. 2 requires the auditor to report significant deficiencies and material weaknesses in writing to both management and the audit committee. It also requires the auditor to attest to whether material weaknesses identified in the assessment of the company's internal controls over financial reporting have been properly disclosed. Auditing Standard No. 2 classifies the deficiencies in internal controls as significant deficiencies or material weaknesses based on the likelihood that the deficiency could result in misstatement and the magnitude of the potential misstatement

A deficiency is considered to be a significant deficiency, as defined by PCAOB Auditing Standard No. 2 if *"there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected"*[24]. Paragraph 10 defines a material weakness as *"a significant deficiency, or combination of significant deficiencies, that*

[23] Public Company Accounting Oversight Board A-70
[24] Public Company Accounting Oversight Board A-9

results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected"[25].

The definition of a material weakness is particularly important because paragraph 27, which addresses the auditors responsibility with respect to the audit of internal controls over financial reporting, states that *"[t]he auditor must plan and perform the audit to obtain assurance that deficiencies that, individually or in aggregate, would represent material weaknesses are identified"*.[26] Furthermore, as indicated in Section 3.2.1, Auditing Standard No. 2 states that deficiencies in Anti-Fraud Programs and Controls are at least a significant deficiency and that fraud of any magnitude on the part of senior management is at least a significant deficiency and a strong indicator of a material weakness. The new standards set by the PCAOB place more responsibility on the independent auditor with respect to Anti-Fraud Programs and Controls than ever before.

3.2.3 The COSO Framework

Auditing Standard No. 2 requires management to use a recognized control framework in its evaluation of internal controls over financial reporting and indicates that the COSO Framework is one such framework. Although it recognizes that other frameworks exist and may be appropriate, paragraph 14 explicitly states that *"the performance and reporting directions in this standard are based on the COSO*

[25] Public Company Accounting Oversight Board A-10
[26] Public Company Accounting Oversight Board A-17

framework"[27]. Therefore, most companies have chosen to use the COSO Framework in assessing their internal controls over financial reporting. The PCAOB provides guidance on how the COSO Framework should be applied in evaluating internal controls over financial reporting and it emphasizes the importance of company level controls, including Control Environment, and Anti-Fraud Programs and Controls. The remainder of this paper will provide a background and overview of the COSO Framework and then apply the COSO Framework to assess the Control Environment of Enron.

[27] Public Company Accounting Oversight Board A-11

4.0 FRAMEWORKS FOR ASSESSING INTERNAL CONTROLS OVER FINANCIAL REPORTING

As discussed above, the PCAOB requires that management adopt a suitable control framework in evaluating the internal controls over financial reporting. While there are various frameworks available, the most common in the North American market are:

- Internal Control – Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"); and

- The Risk Management and Governance/Guidance on Control published by CICA's Criteria of Control Board ("CoCo").

Although both COSO and CoCo are recognized frameworks for assessing internal controls over financial reporting, in reality implementation guidance is limited to COSO. This is a result of the earlier compliance deadlines imposed by the U.S. legislation and the fact that U.S. public companies are choosing to use the COSO Framework in their assessments of internal controls over financial reporting. Furthermore, we note that in general the recommendations of CoCo are not dissimilar or incompatible with those set out in COSO. Accordingly, the COSO Framework will be used for the remainder of this paper as the selected framework for evaluation of internal controls over financial reporting.

4.1 Internal Control – Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission

In order to fully understand the COSO Framework it is necessary to understand how it was developed. The COSO Framework was the product of a study done by a United States National Commission which was formed in 1985 to study the causal factors leading to fraudulent financial reporting and to develop recommendations to reduce the incidence of fraudulent financial reporting. This National Commission came to be known as the Treadway Commission, after its Chairman James C. Treadway, Jr.

- The Treadway Commission was jointly sponsored by five major professional associations in the United States, namely:
- The American Accounting Association;
- The American Institute of Certified Public Accountants;
- Financial Executives International;
- The Institute of Internal Auditors; and
- The National Association of Accountants (now the Institute of Management Accountants).

The Treadway Commission issued the Report of the National Commission on

Fraudulent Financial Reporting in October 1987 (the "Treadway Report"). The three major objectives set out in the report were:

1. *Consider the extent to which acts of fraudulent financial reporting undermine the integrity of financial reporting; the forces and the opportunities, environmental, institutional, or individual, that may contribute to these acts; the extent to which fraudulent financial reporting can be prevented or deterred and to which it can be detected sooner after occurrence; the extent, if any, to which incidents of this type of fraud maybe the product of a decline in the professionalism of corporate financial officers and internal auditors; and the extent, if any, to which the regulatory and law enforcement environment unwittingly may have tolerated or contributed to the occurrence of this type of fraud.*

2. *Examine the role of the independent public accountant in detecting fraud, focusing particularly on whether the detection of fraudulent financial reporting has been neglected or insufficiently focused on and whether the ability of the independent public accountant to detect such fraud can be enhanced, and consider whether any changes in auditing standards or procedures – internal or external – would reduce the extent of fraudulent financial reporting.*

3. *Identify attributes of corporate structure that may contribute to acts of fraudulent financial reporting or to the failure to detect such acts promptly.*[28]

For purposes of its mandate the Treadway Commission defined fraudulent financial reporting as *"intentional or reckless conduct, whether act or omission, that results in materially misleading financial statements"*[29]. The Treadway Commission made recommendations pertaining to the role various parties (including public companies, independent public accountants, the SEC and other regulators and educators) could play in the prevention and detection of fraudulent financial reporting. The Treadway Report became the foundation for the COSO Framework, which is discussed in the following sections.

4.2 An Overview of the COSO Framework

The Committee of Sponsoring Organizations ("COSO") of the Treadway Commission issued a report in September 1992 that provided an integrated framework for assessing internal controls, referred to in this report as the COSO Framework. The COSO Framework broadly defines internal controls as *"a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable*

[28] National Commission on Fraudulent Financial Reporting, "Report of the National Commission on Fraudulent Financial Reporting," (October 1987): Pg. 2.
[29] National Commission on Fraudulent Reporting 2.

assurance regarding the achievement of objectives in the following categories:

- *Effectiveness and efficiency of operations.*
- *Reliability of financial reporting.*
- *Compliance with applicable laws and regulations."*[30]

The COSO Framework also sets out five inter-related components of internal control, each of which is described briefly below:

- Control Environment

  The foundation for all other components of internal control, it sets the tone of the organization, especially with respect to integrity and ethical values.

- Risk Assessment

  Considers how the organization identifies and analyzes risk, as well as how risk is managed.

- Information and Communication

  Considers whether people receive information pertinent to their role and responsibilities in a timely manner and in an appropriate form.

- Monitoring

  Considers how the organization assesses performance of its internal controls, both on an ongoing and period basis. Ongoing

[30] Committee of Sponsoring Organizations of the Treadway Commission, "Internal Control – Integrated Framework," (May 1994): Pg. 3.

monitoring procedures are normally carried out by operating and finance personnel, as part of their regular management and supervisory responsibilities. Periodic monitoring relates to separate evaluations that may be carried out, primarily by internal audit.

- Control Activities

  The detailed policies and procedures that management implements at the process or transaction level to assist in meeting the organization's objectives. These are the internal controls that are most often considered by management and auditors, and include approvals, reconciliations, segregations of duties, etc.

All of the internal control components set out above, except Control Activities, are company level controls.

5.0 CONTROL ENVIRONMENT

Developing an appropriate Control Environment is essential to meeting the objective of reliable financial reporting as it is the foundation that supports all other internal controls components. The COSO Framework describes the Control Environment as setting the ethical tone for the organization, providing moral guidance as to expected behavior and influencing the control-consciousness of the organization's people.

Control Environment is a particularly important aspect of Anti-Fraud Programs and Controls and, in fact the two are inseparable. Both address soft controls such as "tone at the top", corporate culture with respect to the ethics and integrity, communications, rewards and recognition and management attitude towards accounting and financial reporting. Furthermore, how people perceive the organization they work for can play a significant role in motivating people to commit fraud and allowing them to rationalize their actions. A strong Control Environment promotes hiring, retaining and promoting trustworthy and competent people, providing them with guidance on expected behavior, providing training and development opportunities and clearly linking recognition and rewards to performance.

The COSO Framework sets out the following seven factors to consider in evaluating the Control Environment:

- Integrity and Ethical Values;
- Commitment to Competence;
- Board of Directors or Audit Committees;

- Management's Philosophy and Operating Style;
- Organizational structure;
- Assignment of Authority and Responsibility; and
- Human Resource Policies and Practices.

Each of the seven factors impacting the Control Environment is further described in the following sections under the heading Characteristics of a Strong Control Environment.

In order to demonstrate how the COSO Framework can be used to identify Control Environment weaknesses and related fraud risks, Enron has been selected as a case study. For purposes of this analysis the author has assumed that the book *Power Failure: The Inside Story of the Collapse of Enron*, which was co-authored by Mimi Swartz and Sherron Watkins (the whistle-blower), accurately portrays the facts of the Enron story. Using the information culled from *Power Failure* and applying the COSO Framework, the author has made a Control Environment assessment of Enron, identifying weaknesses in the Control Environment that are indicative of the problems at Enron. The facts taken from *Power Failure* with respect to each of the seven factors impacting Control Environment have been summarized in the following sections under the heading Characteristics of Enron's Control Environment. Finally, observations and comments are provided with respect to the Control Environment weaknesses identified and their impact on the fraud risks at Enron. These comments are provided under the heading Conclusion.

The author of this paper recognizes hindsight is 20/20 vision and certain information provided in *Power Failure* may not have been available without the benefit of such hindsight, therefore the objective of this analysis is not to place blame for failure to identify issues or to comment on short-comings of the auditors but, rather to demonstrate how an effective assessment of the Control Environment may have resulted in a timely identification of fraud risks at Enron. Identifying and understanding Enron's fraud risks and Control Environment weaknesses would have led to more questions being asked and a greater degree of skepticism and scrutiny being applied in analyzing transactions and proposed accounting treatments.

5.1 Integrity and Ethical Values

5.1.1 Characteristics of a Strong Control Environment

To develop a strong Control Environment senior management must set standards of behavior that reflect the importance of ethics and integrity and then effectively communicate those expectations throughout the organization. The implementation of a Code of Conduct and other policies that provide guidance on acceptable business practices are the starting point. However, it is not enough to have the policies in place, they must be effectively communicated and understood throughout the organization and embedded in daily business practices in order to be effective. Furthermore, people must believe in management's commitment to the organization's policies and observe behavior from the leaders that is consistent with the expectations set out in the policies.

Communications from management should encourage “doing the right thing” and “not cutting corners to make a quick buck”. Codes of conduct and other important policies should be backed by the appropriate authority and should contain clearly stated consequences for violations or departures from such policies. The Code of Conduct (or other related policies) should also contain a mechanism for reporting of suspected departures, often referred to as a “whistle-blower” mechanism. To be effective, the whistle-blower mechanism should allow for anonymous and confidential reporting of issues and should provide a feedback mechanism. In addition, there should be a structured fraud response plan that provides guidance on handling reported issues, including responsibility for investigation and remediation.

A strong corporate culture exists when people within the organization believe in management’s commitment to conducting business on a high ethical plane, whether dealing with customers, suppliers, investors, creditors, competitors, employees, auditors or the public in general. Management can re-emphasize the importance of ethics and integrity through regular communications, by rewarding behavior consistent with expectations and by ensuring that departures from the policies are investigated and remedial actions taken. Requiring annual written acknowledgement of compliance with the organization’s policies and procedures is another opportunity for management to re-emphasize its commitment to the Code of Conduct. To be effective, the annual compliance process relating to the Code of Conduct should include procedures for following up with those that have not signed the annual declaration.

Two areas that can be particularly problematic with respect to integrity and ethical values are management override of internal controls and unrealistic performance targets. If management is seen as frequently overriding internal controls without explanation or legitimate business purpose and with little regard for the system of internal controls, the control-consciousness of the organization will most likely suffer, reflecting the same cavalier attitude. Accordingly, the organization should establish policies stating that management override is generally prohibited except in certain limited instances, such as when public safety is in question and requiring that management override be documented and explained. Furthermore, a process should be implemented whereby instances of management override are reviewed and followed up.

Studies have shown that unrealistic performance targets, especially when achievement of those targets is linked to compensation, may unduly pressure otherwise honest employees to engage in fraudulent activities[31]. This is particularly true where there are ineffective financial reporting controls, providing opportunity for fraudulent financial reporting with little risk of detection.

5.1.2 Characteristics of Enron's Control Environment

Although there are many facets to Integrity and Ethical Values, for purposes of assessing the Control Environment of Enron this paper will focus on three factors that

[31] One such study was done by Kenneth A. Merchant, Fraudulent and Questionable Financial Reporting: A Corporate Perspective (Morrison, NJ: Financial Executives Research Foundation, 1987).

have been identified as being particularly relevant to Enron. The three factors upon which this paper will focus are:

- corporate culture and "tone at the top";
- lack of remedial action in response to departure from corporate policies; and
- pressure to meet unrealistic performance targets.

Culture and Tone at the Top

The Human Resources and Public Relations department of Enron hired an ad agency and developed a campaign to spread the message of Enron's corporate values, decorating Enron's lobby with *"brightly colored banners heralding employees' commitment to Enron's 'Vision and Values': Respect! Integrity! Communication! Excellence!"*.[32] Ken Lay (CEO) and Jeff Skilling (CFO) also performed in a Vision and Values video, talking about the concepts of respect, integrity, communication and excellence, which was distributed to all employees.

However, based on the description in *Power Failure*, these values were certainly not embodied in the corporate culture of Enron. Transactions were veiled in secrecy, several executives were well-known throughout the company for their tantrums and bullying of anyone who stood in their way, those that questioned management's proposed plans or delayed deals by trying to enforce internal controls were labeled as troublemakers and reassigned to less influential positions, and accounting policies were

[32] Swartz and Watkins 5

selected based on their ability to meet earnings targets and keep debt off the balance sheet as opposed to their merit. The following quote from *Power Failure* is just one example that demonstrates how management's behaviour that led to the culture described above:

> *"[Fastow] quickly banished an old hand named Bill Gathmann, who believed in full disclosure with the ad agencies – he'd confessed in early 1998 that Enron might not make its operating cash flow targets. Fastow was livid; to him, the numbers could always be met. By late march, Gathmann was exiled to India for his honesty and Fastow replaced him with Jeff McMahon, the rising star who made a name for himself in London."*[33]

Skilling, in his role as CFO and eventually CEO, promoted a culture that was leading edge, always challenging tradition and status quo. *"He wanted people like himself – ambitious, driven, self-made, with something of an edge. You had to be glib, you had to be aggressive, and, most of all, you had to be able to sell. You also have to have a healthy disrespect for the established order – how else could you keep innovating."*[34] It was a culture that touted risk taking and creativity. "*When one executive told [Skilling] that Enron could not legally trade power without owning it, Skilling's response was to urge him to be more creative. Find a way in which Enron could, he said."*[35] In this environment *"[t]aking 'no' for an answer was a sign of weakness. Whether it was bullying the young zombies in the Risk Assessment and Control Group to sign off on a*

[33] Swartz and Watkins 165
[34] Swartz and Watkins 57
[35] Swartz and Watkins 113

deal – or if RAC refused, going over their heads – or arguing, as young associates did, that their company-issued London apartment should be walking distance to Enron House, life at Enron became a constant test of smarts and status."[36]

This was a culture that appealed to the young people that Skilling liked to hire. *"Skilling hired people who were very young, because very young people did not insist on coming in at nine and leaving at five, or on keeping things as they had always been, or for that matter, on questioning authority once they had signed on with him."*[37] Contrary to the "Vision and Values" campaign, open communication was not necessarily valued at Enron, rather it was an environment in which the senior executives were averse to hearing bad news, which in turn hindered upward communication. A culture developed in which people would go to great lengths to avoid being the bearer of bad news. For example, in one instance Power Failure notes that *"[s]ince no on wanted to tell Skilling that his ideas were flawed, they kept re-doing models instead, and bringing in McKinsey to try to come up with a workable solution."*[38]

Surprisingly, despite the difficult working environment, people flocked to Enron. *"There was pressure, there was abuse, there were near-psychotic levels of competition, but everyone knew they were just a deal away from making it really, really, big. You just had to hang in there; leaving Enron would be like a star reporter quitting the New*

[36] Swartz and Watkins 192
[37] Swartz and Watkins 57
[38] Swartz and Watkins 113

York Times or an honor student walking away from Harvard or a bound-for-glory baseball player abandoning the Yankees – anything else was going to feel like step down. Did you want to work with average people who made average incomes and had average ideas?"[39]

What developed was an environment in which the deals were closed at all costs and earnings targets were met no matter what it took. Some people, like Keith Powers, learned the hard way that challenging senior management was career suicide. In 2000 Keith Powers, an employee in the Risk Assessment and Control Group ("RAC"), raised concerns with Rick Buy (Chief Risk Officer) with respect to his perception that Enron had overvalued the assets in its Joint Energy Development Investments ("JEDI')[40] portfolio and was told to mind his own business. In May 2001 Powers came across a report by a highly regarded stock analyst named Mark Roberts that summarized Roberts' concerns with Enron, including the following:

- A belief that Enron was overvalued;
- Concerns over Enron's risk management practices;
- Questions over the quality of Enron's earnings and its "incomprehensible balance sheet";
- Indications that "Enron may be utilizing certain types of transactions and accounting techniques to manage and boost earnings"; and
- The large volume of stock sales by Enron's senior executives.

[39] Swartz and Watkins 134
[40]JEDI was a portfolio created by Enron to hold natural gas related investments.

Again Powers raised his concerns, distributing the report to six vice presidents in RAC. Two days later, Rick Buy confronted Powers and told him that he should not have distributed the report and that is was a career-terminating step. Powers was also told under no circumstances should he give the report to anyone else and that he should forget he ever saw the report. *"Three days later, Powers got the news that he was being transferred to the Trade Credit Group, which for a RAC manager was like being sent to Siberia, long hours, little reward. Powers was angry. When Kinder was at Enron, he told his boss [Buy], people thrived on being challenged, they loved to duke it out. Now, he said, he was working for a company that couldn't confront bad news. What did that tell you?"*[41]

The following passage from *Power Failure* paints a vivid picture of the dichotomy between the face that Enron showed the world and the face that only those inside Enron saw:

> *"As the millennium approached, the company's growing success in fact bred two Enrons. The first was the idealized Enron – the Enron that the New York Times called 'a model for the new American Workplace – every bit as much as the Silicon Valley start-ups that usually come to mind when the subject is entrepreneurship or innovation' – the company that routinely landed on Fortune's lists of the most innovative and best companies to work for in America. The survey Enron submitted to Fortune's '100 Best Companies to Work for in America' poll made Enron sound like corporate heaven: 'On many of our floors the offices have glass walls or no walls at all, even for management,' the scribes*

[41] Swartz and Watkins 259

in the PR department wrote. 'Nothing is hidden, secrecy is passé.' Enron was benevolent: 'If employees fail, there is no time for recrimination because they are already in hot pursuit of the next opportunity.' Enron's leaders were the kind of guys you'd want for your best friends: 'Ken, [and] Jeff, . . . clearly set the tone for how the rest of the company operates. They are friendly, approachable and ready to listen. They say hi in the elevator and ask how you are doing . . . they personally read and reply to all employees' suggestions and comments and they hold open forums for discussion at floor meetings . . . [T]heir passion for new ideas and ways of doing things has sparked the creativity among employees that is building brand-new markets around the country and the world'.

But Enron insiders knew hype when they saw it. Contributors to Fortune's 100 Best Companies to Work for in America' survey were supposed to be selected at random from within their companies. But at Enron, the same executives in Human Resources and Public Relations filled out the forms every year, creating out of thin air the corporate oasis that annually ranked higher and higher on the business presses' laudatory lists.

Eventually, Enron employees came up with a different name for their company: The Bizarre Social Experiment. This company was forever reorganizing, so no one every really knew for whom they were working or what, exactly, they were supposed to be doing. This company put ever-younger and less-experienced people in charge of business units. This company threw ungodly amounts of

money at new business concepts. This company devoted itself to perpetual and monumental change: As Ken Lay liked to say, 'In the years to come we expect the majority of our profits to come from businesses that we aren't even in today.' Unless, of course, the market suggested you were unfocused, and then it was time to backtrack.

In other words, despite the great press, Enron was a company enveloped in chaos." [42]

<u>Lack of Remedial Action by Senior Management in Response to Departures from Corporate Policies</u>

As early as 1987, just two years after the merger that created Enron, a significant departure of corporate trading policies was discovered. There had been warning signs raised by Arthur Anderson about the Valhalla Trading Group, which was inherited from InterNorth in the merger, as early as 1985. In 1987 prompted by a call from a New York bank regarding unusually high-dollar transactions, an investigation was undertaken. The investigation, which was led by Ken Lay and Rich Kinder (COO), quickly identified problems including ill-gotten gains and a second set of books which were maintained to show Enron (the parent company) and Arthur Anderson.

The decision that Ken Lay made next, would be the start of a long-term cultural problem at Enron. With his new company facing bankruptcy, Lay *"shocked his colleagues with his decision: The traders would not be fired. Enron would simply*

[42] Swartz and Watkins 134

institute and enforce stricter controls . . . he obtained promises of reform from the traders, and, more important, an unstated guarantee that the past trading profits would continue."[43] This decision was critical because it sent a message that departures from policies, even alleged fraud, would be overlooked in order to ensure the profitability of the company. Furthermore, while Ken Lay indicated that "stricter controls" were the answer, it appears that they were never in fact enforced because within a short time the same traders, ignoring company-imposed trading limits, undertook transactions that would result in a *"position that had the potential to wipe out almost all of Enron's 1987 earnings"*[44].

Despite the intervention of a seasoned trader, Enron was only able to reduce the loss stemming from the actions of the two rogue traders to $150 million dollars. Although the two traders involved were ultimately dismissed and faced prison time and/or probation and paid fines, the devastating losses that Enron suffered could have been avoided altogether had Ken Lay taken more severe action when the first instance of fraud was discovered. This would not be the last time that senior management's reluctance to take disciplinary action would impact Enron. Over the years, various people raised concerns over Enron's aggressive accounting, unusual transactions and Fastow's conflict of interest but in all cases senior management and the Board failed to take any remedial action, and instead focused on defending the actions of senior management and punishing the employee raising the concern by reassigning them to an undesirable position within the company.

[43] Swartz and Watkins 32
[44] Swartz and Watkins 32

Pressure to Meet Unrealistic Performance Targets

The pressure to meet earnings targets was the driving force behind many of the fraudulent activities that took place at Enron. The focus of the 1999 management conference was "growing earnings" and Skilling was expecting growth of 20 percent a year. In fact, Skilling was in the habit of making annual predictions for Enron's stock price and somehow his prediction always seemed to be right on the mark. *"In years past he has been on the money – Enron had gone from $40 to $60 a share in 1998, and soared to $80 in 1999. Now [at the November 2000 Management Conference] he stood before his faithful and bowed his head, as if to think about what he had to say. When he looked at the crowd again, he was beaming. Enron stock, he told them, would hit $126 a share in 2001 [at a time when stock was trading at $67 per share]. There was just a second of stunned silence before the crowd burst into applause. No one knew quite how the stock was going to increase another 30 percent, even with the succession of Broadband, which was not exactly a sure thing. . . But no one was that worried. They reminded themselves that they worked for Enron and, no matter what, Jeff would find a way. Because he always did."*[45]

In 1997 the Performance Unit Plan was introduced, providing opportunities for senior management to earn significant bonuses if, by 2001, Enron was ranked in the top six companies on the Standard & Poor's Index for return to shareholders. With an increased focus on shareholder value, *"Enron began projecting, and then miraculously meeting, earnings targets four times a year, to glowing reviews from analysts and the*

[45] Swartz and Watkins 12

business press. A company that missed its numbers got the same treatment in reverse: Wall Street analysts would hammer the company and the stock price plummeted."[46] In the beginning this focus on making the earnings targets resulted in Enron "cutting the fat" and outsourcing certain roles, including "*various divisions that had once been considered crucial, like internal audit"*[47]. Even after Enron had outsourced all it could, pressures to meet earnings targets continued and Enron had to get more creative. *"Another quarter, Enron made earnings by selling and leasing back its building."*[48]

The focus on earnings targets also resulted in pressure to consolidate divisions and close more deals. This is where LJM and LJM2[49] became important. *"By early 2000, [LMJ2] was the most direct path to success inside the company. Even if you didn't like Andy[Fastow] – and by now a great many people didn't like him because he was bullying Enron executives along with the bankers – you still had to make your earnings targets to survive at the company. If you couldn't find a buyer for an asset sale (and selling assets was the name of the game under Skilling), or you couldn't close a finance deal before the end of the quarter, well, now LJM2 was an option. It would buy what needed buying, or finance what needed financing – in other words, LJM2 would help you close the deal, hit the targets, and, of course, win the bonus."*[50]

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[46] Swartz and Watkins 69
[47] Swartz and Watkins 69
[48] Swartz and Watkins 69
[49] LJM and LJM2 were investment partnerships that would enter into deals with Enron, structured so that Fastow was the owner of the outside investment partnership. The underlying purpose of the LJM and LJM2 structures (i.e. the reason that Skilling backed the proposed transaction) was to allow Enron to meet its earning targets and keep debt off the balance sheet.
[50] Swartz and Watkins 210

Keeping the stock price up was also important because many of the off-balance sheet vehicles contained debt acceleration triggers if the price of Enron stock dropped below a certain level. Not surprisingly, return to shareholders and earnings targets became the focus for Enron, driving not only business decisions but also accounting decisions. Enron executives achieved the goal that had been set for them, increasing the return to shareholder from only 9% for the three-year period from 1995 to 1997 to 55% for the period from 1998 to 2000. No one seemed to care how the goal had been achieved and the large bonuses that had been promised to senior management were paid out, with Ken Lay, Jeff Skilling and Andy Fastow at the top of the pack, receiving $3.6 million, $2.0 million, and $1.7 million respectively. These bonuses were insignificant however, to the approximately $60 million that Fastow was received through the LJM and LJM2 partnership. At one point Fastow told an Enron lawyer that *"[i]f Skilling ever knew how much money he'd made, Skilling would have no choice but to shut down LJM entirely."*[51]

It was well known at Enron that *"[i]f you made big money for the company, you could do no wrong"*[52] Conversely, groups such as the RAC, whose job it was to analyze and question proposed transactions, came to be seen as troublemakers that unduly slowed down the dealing making process. After all, closing the deal meant not only survival but also great wealth since incentive compensation that accompanied the deal could be a significant portion of an employee's salary.

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[51] Swartz and Watkins 254
[52] Swartz and Watkins 38

5.2 Commitment to Competence

5.2.1 Characteristics of a Strong Control Environment

The COSO Framework recommends that management be involved in determining the requisite skills and knowledge required for a particular job, and in ensuring that employees have a level of competence appropriate to the role they are fulfilling. Training and development programs should be implemented to ensure employees possess the necessary skills to effectively carry out their duties and responsibilities. Formal or informal job descriptions should be used to communicate roles and responsibilities to employees. Furthermore, there should be evidence, such as performance evaluations, demonstrating that employees do, in fact, have the requisite knowledge and skills to perform their job.

In order to effectively carry out their job functions, including control activities, employees require three things; first, they need a clear understanding of their roles and responsibilities, second they need to have the appropriate knowledge and skills to do the job, and third they need to be motivated to fulfill their responsibilities. Take for example the bank reconciliation process, which is an important control activity. In order for that process to be effective, it not only has to be appropriately designed, it also requires that the person performing the reconciliation understands the key controls and has the skills necessary to perform an effective review and is motivated to carry out those functions. If all three conditions do not exist the employee will either be unable or unwilling to fulfill their control responsibilities.

5.2.2 Characteristics of Enron's Control Environment

While Enron is described as having priding itself on being *"intellectually competitive",* hiring only the best and the brightest, it appears from examples provided in *Power Failure* that competence was not always the key consideration in determining who would fill key control positions within the organization. Take Vince Kaminski for example. As Enron's head of research, he appears to be one of those people whose probing questions and reluctance to accept senior management's proposals without critical analysis resulted in his being reassigned to a less influential position within the company. Kaminski is described as part of *"Enron's brain trust"*[53], a man whose *"credentials were beyond reproach, even in the intellectually competitive hothouse of Enron"*[54]. When asked to price some put options in relation to a special-purpose entity ("SPE")[55] that would become LJM, Kaminski expressed his discomfort. He indicated that he felt the deal was a conflict of interest since *"Fastow was serving both as Enron's CFO and the owner of the outside investment partnership"*[56] as well as pointing out the unstable structure of the proposed transaction. The transaction progressed despite Kaminski's objections and Vince was reassigned. *"Skilling didn't like his attitude. He was killing too many deals."*[57]

Another example of Enron reassigning people who challenged what they perceived to be inappropriate behavior of management was the reassignment of Jeff McMahon, the

[53] Swartz and Watkins 168

[54] Swartz and Watkins 168

[55] According to *Power Failure*, Special Purpose Entities were a popular financial vehicle that allowed a company to borrow money against a specific group of assets and treat the transaction as a sale. The result was that companies could expand without increasing the debt recorded on the balance sheet.

[56] Swartz and Watkins 171

[57] Swartz and Watkins 173

treasurer of Enron, in 2000. McMahon was, at one time, one of Enron's heroes, having come up with the idea to temporarily "sell" three barges to Merrill Lynch until a third party buyer could be found, a transaction that allowed Enron to book $12 million in profits, thus meeting its 1999 earnings target. However, with the creation of LJM and LJM2 McMahon found himself reporting to a CFO with conflicting interests. *"Since 1999, Fastow has been running a bifurcated division – there was finance, under McMahon, and there was LJM, under Kopper. When the two came into conflict, it was no longer a mystery who would win."*[58] Further, McMahon was fielding complaints from employees who claimed that Fastow *"would punish them in the PRC* [Performance Review Committee] *if they pushed too hard on a deal for Enron that ran counter to the interests of LJM2."*[59]

McMahon voiced his concerns over Fastow's conflict of interest to the CEO, Jeff Skilling. Skilling told McMahon that he understood his concerns and that the situation would be remedied, however a few weeks later McMahon was summonsed to Fastow's office. *"When he arrived, McMahon found his boss pacing the office, red-faced, furious. He didn't know whether the two of them could work together anymore, Fastow told McMahon coldly. He knew that McMahon had gone to Skilling. Didn't he realize, Fastow said, that everything McMahon had said to Skilling got back to him?"*[60] Within

[58] Swartz and Watkins 218
[59] Swartz and Watkins 217
[60] Swartz and Watkins 219

a few hours of that meeting McMahon was reassigned to a position that *"would make better use of his skills"*[61].

Senior management of Enron also had a tendency to put into key control positions people who were easily controlled. For example, certain people at Enron believed that Rick Buy, Enron's Chief Risk Officer, was appointed to his position primarily as a result of his malleability rather than his competence in his role. They likened him to *"a burnt-out beat cop – one who could spot trouble, but who had given up trying to improve the neighbourhood"*[62]. Nepotism was also known to occur at Enron. For example, *"Lay gently but firmly insisted the company use his sister Sharon's travel agency, and put his son Mark on the payroll."*[63] In another instance, Lay obliged the request of George W. Bush by *"putting Reed on the Enron payroll"* [64] to keep him from straying to another candidate. Ken Lay was not the only person guilty of nepotism. *"Unbeknownst to most at the company, [Fastow's wife] was paid $54,000 to be a Chewco administrative assistant."*[65]

5.3 Board of Directors or Audit Committees

5.3.1 Characteristics of a Strong Control Environment

The COSO Framework emphasizes the importance of the oversight role played by the board, and in particular the audit committee, in ensuring the effectiveness of internal

[61] Swartz and Watkins 219
[62] Swartz and Watkins 168
[63] Swartz and Watkins 36
[64] Swartz and Watkins 119
[65] Swartz and Watkins 164

controls over financial reporting. The oversight role that the board and the audit committee is charged with is particularly important given management's ability to override internal controls. Accordingly, the COSO Framework sets out several factors to be considered in assessing the effectiveness of the board and audit committee.

The COSO Framework states that consideration should be given to such factors as *"the board or audit committee's independence from management, experience and stature of its members, extent of its involvement and scrutiny of activities, and the appropriateness of its actions. Another factor is the degree to which difficult questions are raised and pursued with management regarding plans or performance. Interaction of the board or audit committee with internal and external auditors is another factor affecting the Control Environment."*[66]

In the current business environment, following the rash of corporate failures surrounded by scandal, boards and audit committees in general are under more scrutiny than ever before and the PCAOB specifically requires that the external auditor to consider audit committee effectiveness. Furthermore, PCAOB Auditing Standard No. 2 states that an ineffective audit committee is at least a significant deficiency and a strong indicator of a material weakness. Accordingly, this is an area of the Control Environment that should receive considerable attention.

[66] Committee of Sponsoring Organizations of the Treadway Commission 26

5.3.2 Characteristics of Enron's Control Environment

Based on the portrayal in *Power Failure*, the Board failed to question critical decisions. For example, when Andy Fastow, the CFO, presented to the board on "Chewco", a new SPE designed to allow off-balance sheet treatment of debt, no one at the meeting questioned the source of the 3% at risk equity required to qualify the transactions as an SPE before approving the transaction. In reality Michael Kopper, an employee of Enron and Fastow's second-in-charge was the "third-party" investor and managing partner of Chewco.

On June 28, 1999 the Enron board waived the conflict of interest requirements that would have prevented the formation of the LJM partnership an SPE that would be managed by Andy Fastow (CFO). As the authors of *Power Failure* point out, *"[t]his deal presented a clear conflict of interest. The CFO of the company would be running a partnership with interests that could run counter to Enron's."*[67] Furthermore, the CFO would have an ownership interest in LJM and LJM would receive a put fee from Enron. The hedging structure was described by Vince Kaminski, Enron's head of research, as *"skewed against Enron's shareholders"*[68] creating a situation in which *"[h]eads Fastow's partnership wins, tails Enron loses"*[69]. Still, the Board approved the transaction.

[67] Swartz and Watkins 171
[68] Swartz and Watkins 171
[69] Swartz and Watkins 172

Shortly thereafter in the fall of 1999 Fastow began working on a second venture, LMJ2. Fastow's behavior in promoting LJM2, as described in *Power Failure*, was clearly in conflict with his role as CFO[70]. *"For LJM2, Fastow wanted clients of his own, and after a kick off fund-raising dinner with Merrill Lynch he hit the road, beating the drums for his venture. 'I know where the value is at Enron,' he would brag, pumping up his potential investors on the promise of LJM2. His behavior was startling to people in the investment community. Why was the CFO of a $35 billion company, whose traditional responsibilities included maximizing the value to shareholders, telling potential investors to contribute to another fund that could, essentially, raid the parent company? Even stranger was the actual makeup of LJM2 – anyone who looked carefully at the fund would see that it didn't hold assets, exactly, but entities within entities that held assets."*[71]

While promoting LJM2 at a conference of Wall Street bankers Fastow once bragged of his unique role at Enron and LJM2: *"Do I know everything that's going on? Do I sign off on every deal that goes on there? Yes. So I'm in the unique position of not having the ownership or responsibility or obligation to sell assets, but I know everything about them and I've been involved in their approval and maybe their structuring."*[72] This conflict of interest, which troubled Vince Kaminski, was apparently not a concern to the Board because in October 1999 they again waived their conflict of interest rules and approved LJM2.

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[70] The fact that Fastow approved deals and had ultimate responsibility for the accounting for such transactions also represents a significant lack of segregation of duties.

[71] Swartz and Watkins172

[72] Swartz and Watkins 208

On October 17, 2001 the Wall Street Journal ran a story questioning the LJM arrangement. *"While the company says that this arrangement was proper, some corporate governance watchdogs have questioned whether a chief financial officer, who is responsible for overseeing the financial interest of the company, should have been involved in such a partnership that was, among other things, looking to purchase assets from Enron,"*[73]. Charles LeMaistre, an outside director of Enron, responded by saying that LJM was a way to keep an invaluable employee and that *"[w]e try to make sure that all executives at Enron are sufficiently well-paid to meet what the market would offer,"*[74]. In fact, Fastow made nearly $60 million from LJM and LJM2.

Power Failure indicates that:

> *"Board member Charles LeMaistre had actually tried to investigate Fastow's compensation before. In May 2000, Fastow told the board that he was spending about three hours a week on LJM, and that he was earning an 18 percent rate of return for his trouble. Assured that Skilling, Buy, and Causey were reviewing every one of Fastow's transactions,* ***the board didn't pry.*** *Ken Lay had appointed the board members and they trusted his word and the word of his people. Many members were older men, polite and deferential, in awe of not just Lay, but mavericks like Skilling and Fastow. Then, too, Lay* ***paid his board members well****, in accordance with the times – on average, over $300,000 a year. Finally, no one*

[73] Swartz and Watkins 305
[74] Swartz and Watkins 306

had really demanded much of them in the past, so they remained, for the most part, ***obedient, loyal, and incurious****. [emphasis added].”*[75]

In 1999 Enron devised “Raptors”, to hedge the value of its equity merchant portfolio. These hedge structures, which were extremely complex, were presented to the Board once in May 2000. *Power Failure* notes that:

“The Enron board did not know all the details of this transaction. Ben Glisan made one presentation on Project Raptor to the board in May 2000, noting that the project did not “transfer economic risk but transfers P&L volatility.” No one probed further. At the same meeting Rick Causey assured the finance committee that Andersen was comfortable with the proposed transaction. Glisan also presented a chart that showed the three principle risks of Raptor:

- *Accounting scrutiny*
- *A substantial decline in Enron stock price*
- *Counterparty credit*

He had solutions for every problem. In the first case, Causey and Andersen approved the transactions. Second, if the stock price declined, Enron could negotiate an early termination of Talon with LJM2. As for the credit, the assets of Talon were subject to a “master netting agreement” – meaning that amounts owed by Enron for hedges on poorly performing assets could be offset by gains on the stellar assets. (No one knew that only poorly performing assets were hedged

[75] Swartz and Watkins 309

in Talon/Raptor/LJM.) The finance committee approved the deal that day, and the full board signed off the next day, May 20, 2000."[76]

5.4 Management's Philosophy and Operating Style

5.4.1 Characteristics of a Strong Control Environment

The COSO Framework recognizes the pervasive effect that the philosophy and operating style of management have on an entity. Factors to be considered under the COSO Framework include:

- the nature of business risks accepted;
- personnel turnover, especially in roles with key control responsibilities such as accounting, data processing and internal audit;
- management's attitude toward the accounting function, in particular, financial reporting and safeguarding of assets; and
- the frequency of interaction between senior management and operating management.

In a strong Control Environment senior management takes an appropriate view with respect to the accounting function and the selection of accounting principles and policies. The accounting function is viewed as an important control within the organization and given adequate resources to carry out its mandate. The attitude toward selection of accounting policies is not overly aggressive or conservative (i.e. selection of policies is not based solely on the financial statement impact). There is a process for evaluation and selection of new accounting policies that is based upon due

[76] Swartz and Watkins 229

consideration of generally accepted accounting principles and industry practice. In making estimates that require judgment, reasonable assumptions are used which do not *"stretch the facts to the edge of reasonableness"*[77] and management does not ignore inappropriate actions with respect to financial reporting. In addition, management does not place excessive focus on short-term results, providing motivation for employees to manipulate financial results in order to meet unrealistic targets.

Also conducive to a strong Control Environment is the monitoring by management of excessive turnover in keys areas, particularly where people with key control responsibilities have quit unexpectedly. Significant turnover can be indicative of underlying problems. For example, inability to retain financial or internal audit staff may be the result of people feeling that they are unable to perform their role effectively due to insufficient resources, insufficient authority, or actions of senior management such an override of internal controls. Alternatively, turnover in key control-related functions can result from management reassigning or firing people that interfere with management's underlying objectives.

5.4.2 Characteristics of Enron's Control Environment

Ken Lay is described as a visionary that embraced change, believing that rules were meant to be broken. Enron however took risk taking to an extreme. There was a belief among certain senior executives that the *"[b]iggest rewards . . . went to the company that took the biggest risks"*[78]. Skilling, in his role as COO, regularly made aggressive

[77] Committee of Sponsoring Organizations of the Treadway Commission 13
[78] Swartz and Watkins 106

predictions with respect to growth in stock price and luckily for him Fastow was of the view that the numbers could always be met. No matter what business challenges Enron faced with respect to its earnings targets, Fastow was always able to deliver a solution that allowed Enron to meet its earnings targets.

By 2001 the selection of accounting policies at Enron was driven almost exclusively by the maximization of earnings and keeping debt of the balance sheet. Although Enron always took an aggressive approach to revenue recognition, its accounting policies continued to get more creative over the years. Eventually, Enron was undertaking transactions solely for the purpose of increasing book earnings and keeping debt off the balance sheet. However, Enron's transition from aggressive accounting practices to outright fraudulent financial reporting was an evolutionary process.
The first described instance of Enron's challenge to conventional accounting policies came when it decided to borrow from the construction industry the *"construction while in progress"*[79] method of recognizing earnings. Under this approach revenues on energy plants that Enron was contracted to build were recognized when contracts were executed rather than when the plant was operational. At the same time Enron's deal-makers that were heading up these project development deals negotiated compensation based on the net present value of the deal paid at the time of closing rather than when the plant went on line.

[79] Swartz and Watkins 37

"Then, in 1991, Enron Gas Services' recently hired assistant controller Rick Causey convinced the Securities and Exchange Commission to allow Enron to account for its trading profits by using a method called 'mark-to-market accounting.' This method was common in the financial industry, where so much money was going in and out the door – to be paid and collected a few years hence – that old-fashioned accrual accounting was useless . . . No energy firm had ever asked to use this method before. But Enron asserted that the value of its product fluctuated just as wildly as any trading company. It, too, had to know its credit risk at all times. The SEC agreed, and from then on, Enron could, for example, buy gas from a supplier at $2mmbtu ten years into the future and sell gas to a power plant at $3 per mmbtu for the same period, and recognize all the profits right away. Enron convinced the SEC that it should treat each contract separately, to accurately measure its credit risk for its shareholders."[80]

In May 1993 an article in *Forbes* identified the risk that under mark-to-market accounting Enron would have to book losses if its contracts lost value and pointed out that *"booking mark-to-market profits set the company on a constant search for growth – Enron would have to book ever more deals every year to show that their income was rising."*[81] And yet Enron was able to convince the SEC to approve this accounting policy. As time went on Enron became increasingly aggressive in its accounting practices, not only selecting aggressive accounting policies but also manipulating its earnings through the use of SPEs and other means. *Power Failure* describes an incident at the end of 1995 in which a young associate identified $70 million dollar

[80] Swartz and Watkins 47
[81] Swartz and Watkins 48

adjustment made to the book he was managing. He was told that *"[he] shouldn't worry. Enron was just 'correcting and fine-tuning' some of the forward gas price curves. In other words, Enron has made more money during the fiscal year than needed and was moving earnings into the next year"*[82]. The fact that the $70 million reappeared in the associate's book in January is confirmation that Enron was most likely manipulating its earnings.

Then, in 1996 Enron got really creative when it found itself $190 million behind earnings targets. Enron had never fallen short of its earnings targets and it would not start now. *"[W]ith a $190 million earnings hole to fill, squeezing earnings from the JEDI equity investments became the focus of the rescue efforts. Enron's transaction accountants, an elite group hired in the early nineties by Rick Causey to develop Enron Capital & Trade's cutting-edge techniques, came up with the idea of revaluing those assets. It could be the salvation Enron was looking for. Just as Enron has used mark-to-market accounting to recognize the full value of long-term oil and gas trading contracts immediately, the future value of the companies ECT had acquired could now be used to resuscitate the company's current bottom line. It was a matter of redefining the nature of ownership. If Enron could prove, according to generally accepted accounting principles – GAAP for short – that these assets were being held for resale instead of as part of the company's core investments, and that a market existed for them, Enron could include unrealized gains in the 'fair value' of those assets*

[82] Swartz and Watkins 88

immediately. In fact, the accountants reported, there were enough assets now in the JEDI portfolio to solve the problems for the quarter."[83]

In 1997 and 1998 Enron was facing having to report a loss again, this time as a result of falling stock price on an investment in Promigas, which was being accounted for at fair value under the mark-to-market method. The solution adopted by Enron was to open a brokerage account and have Enron employees buy shares in Promigas at each quarter end. Given that the company was relatively small the purchases by Enron's staff drove up the stock price and, Enron used these higher stock prices to write-up the investment. *"This went on for several quarters, until the stock price eventually fell so low that Enron could not continue the charade. At that point, Enron went back to the drawing board, adding a 'control premium' for any potential buyers for its 40 percent stake in the company, and, in the process, making up for the shortfall between Promigas's currently traded stock price and Enron's now inflated book value for the investment."*[84] In 1998 virtually all of Enron's increase in earnings related to fair value accounting, which is essentially "*booking future profits or inflating the value of Enron's assets"*.[85] Other tactics used by Enron to obscure its true financial picture included reorganizing so that "*losing businesses were grouped into a pro forma 'nonrecurring' or noncore reporting group."*[86] In fact, Enron reported earnings of $425 million for the first quarter of 2001 as a result of restructuring.

[83] Swartz and Watkins 92
[84] Swartz and Watkins 127
[85] Swartz and Watkins 140
[86] Swartz and Watkins 135

In 1996 when Fastow took over the CFO position from Skilling *"[he] took the title but made clear his profound lack of interest in the day-to-day requirements of the job – cash management and commercial report funding, for instance. He just used the position to solidify his power base with Skilling, to whom he was now a direct report. His passion remained with his SPEs."*[87]

These SPEs or special purpose entities were created in response to Enron's growing need for off-balance sheet debt. The purchase of Portland General put Enron at risk of violating its debt covenants unless it could find a way to replace Enron as the plants owner of record. *"The only viable alternative was to employ an SPE, one that would leave Enron as a de facto owner from the perspective of its third-party partners, but not the owner as far as the regulators were concerned."*[88] Fastow arranged for the three percent outside equity to be provided by friendly investors that would not ask many questions, also known as Friends of Enron.

Over the years Enron created more SPEs to avoid booking debt and/or to avoid reporting losses, including multiple Raptors, Chewco (in which Michael Kopper, Fastow's direct report provided the "outside equity") and LJM and LJM2, investment partnerships that would enter into deals with Enron, structured so that Fastow was the owner of the outside investment partnership. In the end LJM and LJM2 not only served Enron's purpose of manipulating its reported earnings and/or financial position but they also made Fastow very rich.

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[87] Swartz and Watkins 159
[88] Swartz and Watkins 158

5.5 Organizational structure

5.5.1 Characteristics of a Strong Control Environment

The Organizational Structure component of Control Environment addresses not only the structure, but also the adequacy of definition of the responsibilities, knowledge and experience of key managers, and the appropriateness of reporting relationships. Organizational structure plays a role in the Control Environment because it establishes reporting lines. Reporting lines are particularly relevant to the effectiveness of internal control functions. Consider, for example, the reporting line of the internal audit department. If the Director of Internal Audit reports to the CFO, he or she will likely be in a position of conflict as they are being charged with evaluating and reporting on controls that are, to a large extent, the responsibility of the person to whom they report. The COSO Framework recommends that *"the internal audit department should have unrestricted access to a senior officer who is not directly responsible for preparing the company's financial statements and has sufficient authority to ensure appropriate audit coverage and to follow up on findings and recommendations"*[89]. Ideally, the Director of Internal Audit would report directly to the audit committee given its oversight role with respect to internal controls and financial reporting.

The appropriate organizational structure (i.e. centralized versus decentralized) will depend upon the size of the organization and nature of its business activities. There is no one structure that is appropriate for all organizations. From a Control Environment perspective there are important implications of the organizational structure, as it

[89] Committee of Sponsoring Organizations of the Treadway Committee 28

impacts the information flow within the organization and can impact whether information flows upstream, downstream and across all business activities. In a strong Control Environment the organizational structure is such that reporting relationships allow key managers access to the senior executives, and managers have sufficient time and resources to effectively carry out the responsibilities with which they have been charged.

Organizational structures that are overly complex can result in ambiguity with respect to responsibilities, which in turn can result in lack of effective monitoring. Ambiguity over reporting relationships and the resulting lack of monitoring over control deficiencies can also increase fraud risks. The "Make or Break" case study provided for illustrative purposes in Appendix D provides a real life example of this type of problem. Alternatively, overly complex organizational structures can be used to obscure the true nature of transactions in order to conceal fraud and misconduct on the part of senior management.

5.5.2 Characteristics of Enron's Control Environment

The knowledge and experience of employees in key internal control functions is an issue that is addressed in this paper under the Commitment to Competence component. As detailed in section 5.2 of this paper, on several occasions Enron promoted or reassigned people based not on their knowledge, experience or ability to do the job, but based on whether they could be controlled by senior management and prevented from interfering with senior management's underlying objectives.

Power Failure also identifies problems within the reporting relationships at Enron. These issues, particularly as they relate to Fastow's conflict of interest and the reporting of the finance department to a CFO with outside and competing interests, are addressed in section 5.3 of this paper. The remainder of this section addresses the organizational structure itself and the structure of the SPEs designed to allow Enron to keep debt of its balance sheet and/or produce revenue to allow Enron to meet its earnings targets.

The organizational structure at Enron was not only complex[90], it was ever-changing. In one eighteen-month period there were six reorganizations. In fact, reorganizations were so frequent that employees joked "*everyone wrote their organization charts in pencil*".[91] Skilling, on the other hand, prided himself on the fact that Enron was constantly changing and had *"reintegrated – shifted the business hierarchy from the traditional pyramid to the flat organization."*[92]

When Fastow was promoted to CFO in 1998 he took on few of the traditional responsibilities associated with the role. *"It was typical of Enron that he was required to perform few of the duties normally associated with the title, like supervising accounting, projecting cash flow, and budgeting – those responsibilities remained with Chief Accounting Officer Rick Causey. Fastow pushed for the title because, he said, it would help him sell Enron's deals better on Wall Street."*[93]

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[90] See Appendix E for an example Enron's complex SPE structures.
[91] Swartz and Watkins 76
[92] Swartz and Watkins 247
[93] Swartz and Watkins 164

Fastow's dismissive attitude toward the traditional accounting responsibilities that went along with the role of CFO apparently filtered down to his staff. In front of the House Energy Commerce Committee, Dean Powers[94] testified that *"While neither the Chief Accounting Officer, Causey, nor the Chief Risk Officer, Buy, ignored their responsibilities; they interpreted their roles very narrowly and did not give transactions the degree of review the board believed was occurring."*[95] Powers also testified that:

- *Ken Lay was "the Chief Executive Officer of Enron and, in effect, the captain of the ship. As CEO, he had ultimate responsibility for taking reasonable steps to ensure that officers reporting to him performed their oversight duties properly. He does not appear to have directed their attention or his own, to the oversight of the LJM partnerships"*[96].

- *The board of Directors "failed in our judgment, in its oversight duties. This has serious consequences for Enron, its employees, and its shareholders."*[97]

Mr. Powers also criticized Arthur Anderson and Vinson & Elkins (external counsel) for failing to meet their responsibilities and for not being more objective and critical of the disclosure process, indicating that *"[m]anagement and the Board relied heavily on the*

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[94] William Powers, the Dean of the University of Texas Law School was a newly appointed Enron board member selected by Ken Lay to head an internal investigating body after the SEC announced that it would undertake a formal investigation.
[95] Swartz and Watkins 349
[96] Swartz and Watkins 349
[97] Swartz and Watkins 349

perceived approval by Vinson & Elkins of the [LJM] structure and disclosure of the transactions."[98]

5.6 Assignment of Authority and Responsibility

5.6.1 Characteristics of a Strong Control Environment

The assignment of authority and responsibility is another component of the Control Environment set out in the COSO Framework. In particular, COSO addresses the appropriateness of delegated authority and responsibility, adequacy of the workforce and control-related policies such as job descriptions. In general, two different issues can arise with respect to delegation of authority; one in which too much authority is delegated with out effective oversight by senior management or the Board, and another in which there is a lack of proper delegation of authority, usually as a result of senior management's desire to conceal the true nature of certain transactions.

While the decision to delegate authority away from senior management and empower front-line employees to make decisions may be a sound business decision, it exposes the organization to different financial reporting risks. As a result of delegation, senior management will be less involved in certain business decisions, therefore additional controls may be necessary. In delegating authority it is important that the Board and senior management are aware of control implications and that they respond with appropriate internal control measures in order to maintain an effective Control Environment. This starts with a logical and reasoned process for delegating authority,

[98] Swartz and Watkins 349

taking into account the skills and knowledge of the person to whom authority is being delegated and an assessment of their understanding of their role in achieving the control objectives of the organization. It is also important that effective monitoring controls are implemented by senior management and by the Board.

In order to ensure that employees to whom authority is delegated understand the control functions related to their position, COSO recommends that control-related responsibilities be documented, ideally in job descriptions. To ensure competence (i.e. appropriate skills and knowledge), the employees' performance should be evaluated regularly against those criteria. Employees should also understand that they will be held accountable for their actions. Related to this point, responsibility for decisions must be linked to the assignment of authority. To assign responsibilities without delegating the authority necessary to carry out those responsibilities will often lead to frustration and dissatisfaction on the part of the employee, factors that can impact the motivation of an employee to commit fraud against an organization. Conversely, reluctance on the part of senior management to delegate responsibility for routine functions, may be an indicator of fraud or misconduct.

5.6.2 Characteristics of Enron's Control Environment

There was a veil of secrecy that surrounded certain transactions, such as the SPEs. Chewco is one example of a transaction that was surrounded by secrecy and in which senior management was very hands-on, refusing to delegate even the most routine tasks. *"As Chewco was forming, in fact, it seemed veiled in secrecy to many who*

worked in Fastow's group. There was some question, for instance, as to who, exactly, was providing the third-party equity funding for the deal. Paperwork that had once been the responsibility of clerks was now overseen by only one director-level employee, who also oversaw the sending and receiving of all faxes. Boilerplate documents were confined to locked file drawers. During the negotiations of the profit distribution between Chewco and Enron, Bill Brown, a Fastow hire from 1995, received a chilly warning from his boss. Brown was driving too hard a bargain on Enron's behalf, Fastow complained. Brown reminded Fastow that was his job – to get the best deal for Enron, Understood, Fastow replied, but the deal also had to close. Brown left the meeting with an uncomfortable feeling that Fastow was more involved in Chewco than he had initially assumed."[99]

In fact, Chewco was formed to help achieve Skilling's objective of selling part of Enron Energy Services to *"demonstrate its value in the marketplace"*[100]. Enron identified CalPERS as a potential purchaser but in order for the deal to close CalPERS required Enron to buy their investment in JEDI. The problem Enron faced was that purchasing the CalPERS investment in JEDI directly *"would be disastrous for Enron's balance sheet, because all the JEDI debt would then be consolidated with Enron's. If that amount was added to the $383 million purchase price (which would also have to be borrowed), Enron would end up increasing its debt by nearly $1 billion."*[101] The only other option was for Enron to *"create a special-purpose entity, like Alpine and RADR, that would borrow the money to buy out CalPERS, keeping both the JEDI debt*

[99] Swartz and Watkins 162
[100] Swartz and Watkins 161
[101] Swartz and Watkins 161

and the $383 million purchase-price debt off the balance sheet . . . All Enron had to do was find a third party to risk 3 percent of the deal, $11 million of equity money. The other 97 percent of the SPE could come from one of Enron's many willing bankers, who would collect a hefty fee for their participation as a lender"[102]. Fastow had hoped to provide the third-party equity but Skilling and the corporate lawyers refused to approve the transaction because they pointed out that:

> *"An Enron senior executive purporting to be the third party in a special-purpose entity was not really an outside third party as the accounting rules required. Plus, it was a clear conflict of interest, and as such would require approval of the board and disclosure in the company's proxy statement. . . [Fastow's] next suggestion was to make Michael Kopper Chewco's managing partner. Kopper was not a senior executive, so his role in the creation of the SPE would not have to be disclosed in the proxy. No one was going to outsmart the SPE king!*
>
> *Michael Kopper, in fact, was perfect to manage a fund that, as it turned out, no one was supposed to ask any questions about. He could shut down any meddler with a quip or a sneer"*[103].

It is interesting to note that the deal that Fastow proposed with respect to Chewco would give him a piece of the action *"equivalent to the phantom equity Skilling got at Enron Capital & Trade, and Lou Pai [Enron's head Trader] got at Enron Energy*

[102] Swartz and Watkins 161
[103] Swart and Watkins 162

Service."[104.] Furthermore, the objections raised by Skilling and legal counsel to Fastow's participation in the Chewco SPE were apparently not raised when Fastow later purposed the same structure for LJM or LJM2. In fact, in those instances Skilling took the transactions to the Board and received approval to waive the conflict of interest requirement in order to allow LJM and LJM2 to proceed.

5.7 Human Resource Policies and Procedures

5.7.1 Characteristics of a Strong Control Environment

The COSO Framework identifies several human resource policies and procedures that impact the Control Environment, including those policies relating to hiring, training, evaluating, promoting and compensating employees. If appropriate policies are put in place they are an important control aimed at ensuring that only competent and trustworthy individuals are hired and promoted within the organization.

The human resource policies that an organization adopts send a message to its employees, therefore it is important that senior management is cognizant of the message they are sending. COSO states that "*standards for hiring the most qualified individuals, with emphasis on educational background, prior work experience, past accomplishments and evidence of integrity and ethical behavior, demonstrates an entity's commitment to competent and trustworthy people. Recruiting practices that include formal, in-depth employment interviews and informative insightful presentations on the entity's history, culture and operating style send a message that*

[104] Swartz and Watkins 162

the entity is committed to its people. Training policies that communicate prospective roles and responsibilities and include training practices such as training schools and seminars, simulated case studies and role-play exercises, illustrate expected levels of performance and behavior. Rotation of personnel and promotions driven by periodic performance appraisal demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility. Competitive compensation programs that include bonus incentives serve to motivate and reinforce outstanding performance. Disciplinary actions send a message that violations of expected behavior will not be tolerated." [105]

The critical role that human resource policies and procedures play in an effective Control Environment, and in fraud prevention in particular, is often not fully appreciated. Ultimately, it is people who commit fraud, and they do so only when there is opportunity and motivation. Furthermore, a Control Environment that allows employees to rationalize their actions increases the likelihood that they will be involved in fraudulent activities. The policies and practices described by COSO and set out above are designed to reduce the opportunity and motivation to commit fraud, and to reduce the ability of employees to rationalize inappropriate actions by developing a Control Environment where expectations are clear and people are recognized and rewarded for meeting those expectations.

[105] Committee of Sponsoring Organizations of the Treadway Commission 29

Contrast the environment described above to one in which hiring and promoting employees is commonly based on relationships rather than competence (i.e. hiring and promoting friends and family), there is no clear link between performance and recognition (i.e. compensation, bonuses, promotion) and there are no consequences to those who violate company policies. It is understandable that an individual in this Control Environment is more likely motivated to commit fraud and better able to rationalize misconduct and/or fraudulent actions as a result of feeling unfairly treated by the organization.

5.7.2 Characteristics of Enron's Control Environment

Several of the Human Resource related factors are discussed in preceding sections of this paper. For example, Enron's policies and practices, with respect to hiring and promoting individuals is addressed under the Commitment to Competence component in Section 5.5.2 of this paper. Likewise, appropriateness of remedial action and adherence to ethical and moral standards are addressed in conjunction with the Integrity and Ethical Values component at Section 5.1.2 of this paper. The remainder of this section will address three topics with respect to human resources policies and procedures at Enron; namely performance management, incentive compensation, employee satisfaction surveys.

Performance Management and The Performance Review Committee

Skilling introduced the Performance Review Committee to Enron Gas Services as a tool to assist in creating the type of company he wanted. Although the Performance

Review Committee was in theory a 360-degree feedback process, it was abused by senior management of Enron and used to manipulate employees and prevent them from challenging the actions and decisions of senior management.

The Performance Review Committee came to be used by certain senior management as a tool to pressure employees to make decisions that were counter to Enron's best interest. *"[M]any Enron executives believed that Fastow was using the Performance Review Committee process (and its accompanying bonuses) to pressure people into dealing with LJM2 and to punish those who held up deals with his funds "*[106] or to punish those who *"pushed too hard on a deal for Enron that ran counter to the interests of LJM2."*[107]

Incentive Compensation

Much of the behaviour at Enron was driven by incentive compensation opportunities. In 1997 the Performance Unit Plan was introduced, providing opportunities for senior management to earn significant bonuses if, by 2001, Enron was ranked in the top six companies on the Standard & Poor's Index for return to shareholders. Return to shareholder increased from only 9% for the three-year period from 1995 to 1997 to 55% for the period from 1998 to 2000 and the payouts were huge:

Ken Lay	Chief Executive Officer	$3.6 million
Jeff Skilling	Chief Operating Officer[108]	$2.0 million
Andy Fastow	Chief Financial Officer[109]	$1.7 million

[106] Swartz and Watkins 210
[107] Swartz and Watkins 217
[108] Became CEO in 2001

Michael Kopper	LJM Executive[110]	$600,000
Rick Causey	Chief Accounting Officer	$350,000
Rick Buy	Chief Risk Officer	$760,000
Jim Derrick	General Counsel	Approximately $500,000

In addition, many other examples are provided in *Power Failure* of Enron executives and senior management receiving significant bonuses based on short-term financial results. The largest payout however, was not the result of Enron's formal incentive compensation plan but rather stemmed from Fastow's ownership in LJM and LJM2. *"[Fastow's aggregate income attributable to the first LJM, including salaries, consulting fees, management fees, and partnership distributions for his $1 million investments came to $23 million. His $3.9 [million] investment in LJM2 had returned $22 million. The grant total was $58.9 million."*[111] Fastow's behavior, such as the pressure he exerted on Enron employees that were negotiating with LJM or LJM2, demonstrates that his actions were was motivated almost entirely by his interest in LJM and LJM2.

Employee Satisfaction

As indicated in section 5.1, there seemed to be two-sides to Enron; the Enron that that Ken Lay and the Human Resources and Public Relations ("Human Resources") executives portrayed to the business community and the real Enron. Although Human Resources used employee surveys to paint a picture to the outside world of open

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[109] Became CFO in 1998

[110] Michael Kopper was Fastow's protégé and Chewco's managing partner.

[111] Swartz and Watkins 310

communication and an environment where employees could make mistakes without retribution, this did not at all reflect the reality of life at Enron. Those survey results were manipulated by distributing the survey to only those employees that would respond how Enron wanted (i.e. executives of the Human Resources and Public Relations department). In fact, an earlier job-satisfaction survey of the employees showed that *"many were uncomfortable about openly voicing their opinions"*[112].

When all employees finally had the opportunity to respond to The Lay It On The Line survey, which promoted honest feedback, confidentiality, two-way feedback and responsiveness by management to issues raised, they expressed their hatred of the Performance Review Committee, their hatred of the way they were treated by the traders and a few expressed concern over Enron's accounting methods. Although respondents raised concerns with respect to Enron's accounting practices, Human Resources overlooked the importance of the concerns raised, presumably given the low number of respondent making such comments. *Power Failure* states that *"[m]ore that 3,000 people described their hatred of the PRC, while only a dozen people were worried about the accounting."*[113] The report prepared by Human Resources summarizing the results of the survey suggested improvements for the Performance Review Committee but did not address the concerns raised with respect to accounting practices.

[112] Swartz and Watkins 76
[113] Swartz and Watkins 293

5.8 Control Environment Summary

The assessment of Enron's Control Environment revealed a company that was plagued with Control Environment weaknesses, in fact the assessment identified weaknesses in every one of the seven components of the Control Environment. The assessment also identified an abundance of fraud red flags which the author believes could have been identified had a thorough Control Environment assessment been undertaken by an experienced and knowledgeable forensic accountant. The paragraphs that follow summarize the most notable weaknesses/red flags with respect to each of the Control Environment components.

5.8.1 Integrity and Ethical Values

The "tone at the top" of Enron is best summed up as corrupt. Despite a Human Resource campaign that extolled the virtues of respect, integrity and communication, the very actions of senior management demonstrated a complete lack of ethics and integrity. From Fastow's relentless promotion of LJM and LJM2 despite his role as Enron's CFO, to Skilling's demands to do whatever it took to make the numbers, to hiding the true substance of transactions, to Skilling's acceptance of Fastow as the "third-party" investor in LJM and LJM2, senior management was clearly driven by ego (under Skilling's leadership Enron's mission was to be the "World's Leading Company") and greed.

Transactions were undertaken and structured not based on business merit and the true substance of the transactions, but rather based upon the short-term impact they could

have on the financial statements. Skilling's ultra-aggressive annual stock price predictions had to be met somehow, firstly Enron had never not made its numbers, secondly and more importantly, under the Performance Unit Plan significant management bonuses were tied to meeting those targets.

Another issue that was indicative of the poor "tone at the top" at Enron was senior management's failure to take appropriate remedial action in response to inappropriate conduct of management and employees. In response to the Valhalla Trading Group fraud Ken Lay traded leniency for a promise of continued trading profits. The concerns that Vince Kaminski's brought to Skilling with respect to Fastow's inappropriate conduct as CFO given his conflict with LJM and LJM2 were simply relayed back to Fastow without further consequence (for Fastow at least, Kaminski was reassigned!). These actions clearly demonstrate that making the numbers was paramount at Enron. Given the poor "tone at the top" establish by management, the effective oversight of the Board was even more critical, however as discussed in Section 5.8.3, the Board failed in its oversight responsibilities and was not a positive influence on the "tone at the top".

The poor "tone at the top" demonstrated by Enron's senior management (as well as its Board) was a significant Control Environment weakness and red flag. The combination of senior management's lack of ethics and integrity, and an incentive compensation plan tied to meeting aggressive earnings targets resulted in a significant increase in fraud risk, particularly as it relates to financial reporting. In fact, poor "tone at the top"

and the incentive compensation plan are two major factors that contributed to the fraud at Enron.

5.8.2 Commitment to Competence

The senior management of Enron did not demonstrate a commitment to competence, instead they used their power to fill key positions with people they could control, thus allowing them to carry out fraudulent or questionable activities without being challenged. Enron was a company where people who questioned too much or those who were seen as "deal killers" were exiled and put in positions where they were less influential. While those receiving promotion to key roles, were in many cases "yes-men". They were people that had proven they were willing to deliver financial results at all costs, to do whatever it took to close a deal, or those who were simply complacent. Those people who never challenged aggressive accounting treatments and unusual SPEs developed by senior management to manage earnings and keep debt off the balance sheet.

Senior management's lack of commitment to competence, which was evidenced by the frequent reassignment of competent, control-conscious employees should have been a red flag to Enron's Board and auditors, since frequent reassignment and high turnover in control-related functions can be an indicator of fraud. Had these frequent reassignments been questioned, senior management may not have been in a position to override controls by simply getting rid of those employees who tried to enforce them. Instead, senior management was allowed to fill key positions with people they could

control, which in turn enabled them to manipulate the financial earnings reported by Enron.

5.8.3 Board of Directors or Audit Committee

The Control Environment assessment of Enron identified significant weaknesses relating to the Board. COSO suggests that a company's Board and Audit Committee have a significant role to play with respect to the Control Environment, by influencing the "tone at the top" and monitoring the activities of senior management. COSO suggests that the Board and Audit Committee should be involved in evaluating the "tone at the top" and ensuring management's compliance with the Code of Conduct. Not only did the Board not fulfill these responsibilities, they actually waived the conflict of interest rules for Fastow, allowing the creation of LJM and LJM2. The Board's willingness to allow Fastow to enter into arrangements in which he was clearly in a conflict of interest, demonstrates a lack of control-consciousness and effective oversight by the Board.

Had the Board simply refused to waive the conflict of interest rules, many of the problems associated with LJM and LJM2 could have been avoided altogether.

The Board also placed undue reliance on the representations of senior management and on Arthur Anderson's approval of accounting policies. For example, rather than carrying out a review of Fastow's compensation in October 2000 as was planned, the Board took assurance from Skilling, Buy and Causey that they were reviewing every

one of Fastow's transactions. Had the Board undertaken such a review they may have discovered that Fastow was, in fact, receiving tens of millions of dollars from LJM and LJM2. This understanding, along with the knowledge that Fastow was in a conflict of interest position would have caused an effective board to more closely monitor Fastow's activities and scrutinize proposed transactions more closely.

Although the Board included outside directors, they were appointed by Ken Lay, well-paid for their service on the board, and are described in *Power Failure* as being *"obedient, loyal, and incurious"* [114]. In other words they failed to act independently and constructively challenge management's actions. There are several instances identified in Section 5.3.2 of this paper in which the Board appears to have acted as a "rubber stamp". They approved complex SPE transactions with little analysis or questioning of management. For example, the Board meeting at which Chewco was approved, was a meeting conducted via conference call while one Board member was at the airport. As a result, the meeting was rushed and ended abruptly when it was time to board the plane. Given the complexity and significance of the SPE transactions, one would expect significant discussion and constructive challenging of management's plan by an effective board. In addition, *Power Failure* also tells of Enron's Board approving transactions despite not understanding their business objectives and being skeptical as to their purposes.

The Board's failure to challenge management on the structure of the SPEs and to understand the purpose and true identity of the parties behind certain SPEs is critical

[114] Swartz and Watkins 309

because these structures were used to by Enron's senior management to manipulate the financial statements (i.e. overstating profits and keeping debt of the balance sheets). As discussed in Section 5.5, the use of complex business structures that have no apparent legitimate business purpose is a fraud red flag. Had the Board recognized the fraud risks associated which such structures they may have asked tougher questions and demanded more complete responses from management, which ultimately may have led to the earlier detection and/or prevention of further fraud at Enron.

The Audit Committee failed to establish a reporting mechanism for the receipt and investigation of complaints by employees with respect to accounting, internal control and financial reporting matters. Given the Audit Committee's oversight role with respect to financial reporting and given senior management's ability to override internal controls over financial reporting, the establishment of a reporting mechanism was an important Anti-Fraud control that can only be effectively implemented by the Board or Audit Committee.

Based on the portrayal in *Power Failure* it appears that several Enron employees had concerns about Enron's accounting practices, the structure of certain transactions and Fastow's conflict of interest. However, they were either not willing to raise those concerns given the culture or unable to raise them. Because Enron did not have a reporting mechanism whereby employees could bring concerns to the attention of the Audit Committee, employees were left to deal with senior executives, such as Skilling and Fastow, who were in fact the major source of the problem.

Power Failure indicates that many people within Enron experienced frustration stemming from the lack of response from senior management with respect to concerns they had raised over the actions of certain members of senior management and the aggressive accounting policies, and procedures adopted by Enron. It is reasonable to conclude that these people, including Sherron Watkins (the whistle-blower) would have raised their concerns with the Audit Committee had there been an effective reporting mechanism available to them.

5.8.4 Management's Philosophy and Operating Style

The management philosophy at Enron was one of extreme risk taking with an indifference to authority and regulations, in particular as they relate to accounting and financial reporting. Not only were aggressive accounting treatments condoned by management, they were encouraged and enthusiastically embraced. When the accounting policies crossed the line between aggressive and fraudulent, no one seemed to care as long as the end result was hitting the earning targets. Senior management's failure to develop a Control Environment that recognized the importance of the accounting, internal control and financial reporting functions and related accounting policies and procedures is a Control Environment weakness and a significant red flag because it increases the likelihood that controls are overridden or inappropriate accounting policies are selected to manipulate reported earnings. This is in fact what happened at Enron.

Turnover in key control-related roles is another area in which there was a Control Environment weakness and a significant red flag at Enron. As previously discussed, senior management forced turnover in key control positions when employees challenged their actions. Had the Board been monitoring and understanding the causes for turnover in key control positions, this issue may have been identified and further fraud prevented.

Other management style issues that represented Control Environment weaknesses at Enron include the bullying of employees by certain senior executives and senior management's low tolerance for bad news. Enron's culture was to punish those who were the bearers of bad news. Furthermore, even when people did raise concerns, management failed to listen and/or take appropriate action. Senior management's unfair treatment of employees (in particular those in internal control functions), the negative consequences suffered by employees that questioned the actions of senior management, and the lack of remedial action by senior management in response to reported problems, led to a culture in which most employee were not willing to outwardly question or raise concerns with respect to the appropriateness of senior management's actions or decisions.

The lack of open and honest communication at Enron also worked to Fastow's advantage. Details surrounding SPEs were guarded secrets and those that challenged senior management or the transactions they proposed were exiled. In this environment, information that flowed upward was also censored. Concerns raised by employees with

respect to accounting matters, which were a significant red flag of fraud, were never elevated to an appropriate level in the organization (i.e. to the Board). Such concerns should not only have been reported back to Ken Lay, which they were not, but also raised with the Audit Committee, given their ultimate oversight responsibility for financial reporting matters. This weakness in the Control Environment is a significant fraud risk because people are unlikely to report fraud or misconduct due to fear of retaliation and management's lack of remedial action.

5.8.5 Organizational Structure

Enron's use of extremely complex organizational structures whose only apparent business purpose was to inflate profits or keep debt off the balance sheet is a Control Environment weakness and a red flag. In fact, Enron was using these complex organizational structures to manipulate the financial statements. Fastow also employed complex structures to conceal the true identity of certain partners (i.e. Friends of Enron) so that their status as third parties with at equity risk, which was critical to the success of the SPEs, would not be challenged.

Had the Board been fulfilling its oversight responsibilities and had it recognized the fraud risks associated with such complex organizational structures, it presumably would have undertaken a more thorough review and critical analysis of the transactions. Such actions by the Board ultimately may have either prevented, or detected at an earlier point in time, Enron's fraudulent financial reporting. It is impossible to know whether Arthur Andersen recognized and considered the fraud risks associated with the

SPEs and other complex organizational structures. It is, however, probable that a thorough Control Environment Assessment by experienced forensic accountants would have identified such fraud risks.

5.8.6 Assignment of Authority and Responsibility

In Enron's case, there are two issues with respect to delegation of authority: on the one hand, the Board delegated too much authority to senior management without effective monitoring which led to ineffective oversight. On the other hand, senior management was secretive about certain transactions, refusing to delegate even mundane clerical tasks, a clear Control Environment weakness and red flag.

As discussed in other Sections of this paper, the Board did not effectively monitor the actions of senior management. Senior management was essentially delegated full authority for all decisions because the Board was not challenging management's decisions. By giving "rubber stamp" approvals, the Board blindly delegated authority to senior management and failed in its oversight role which is an important aspect of the Control Environment.

The veil of secrecy that surrounded certain transactions, such as Chewco, should have raised the suspicions of the Board regarding the nature and purpose of that particular transaction. The fact that very senior people were personally handling routine tasks and were very secretive about certain transactions should have been an indicator that steps should be taken to find out the true nature of the transaction. However, the Board was

relying very heavily on management to review such transactions and on Arthur Anderson's approval of the accounting treatment. In fact, the secrecy surrounding Chewco stemmed from the fact that an Enron insider that was putting up the 3 percent of at risk equity required to come from a third-party in order for the transaction to qualify for off-balance sheet treatment under the accounting rules.

5.8.7 Human Resource Policies and Practices

The assessment of Enron's Control Environment identified several weaknesses related to Human Resource Policies and Practices ("HR Practices"). Although the details related to some of these topics, such as Commitment to Competence, are addressed elsewhere in this paper, some general comments have been provided here in relation to the Human Resource Policies and Practices.

Enron's practices with respect to hiring and promoting employees, in particular into senior management roles, did not necessarily result in recruiting or developing competent and trustworthy employees. As discussed in section 5.2.2 of this paper, Enron's senior executives promoted "yes-men" that would not challenge senior management on its questionable accounting practices or unusual business structures. On several occasions senior management also demoted or reassigned competent employees in control-related functions who were seen by senior management to be interfering with managements underlying objective. Senior management preferred to replace such "troublemakers" with people that were complacent and easily controlled. The fact that senior management promoted Fastow to CFO despite his dismissive

attitude toward the traditional control-related functions of the CFO position speaks volumes about senior management's control-consciousness and commitment to developing competent, trustworthy staff.

Furthermore, employees' performance was not necessarily evaluated and rewarded based on fulfilling their stated job responsibilities, as COSO recommends. *Power Failure* indicates that at certain times the constant reorganizations caused so much confusion that employees and their supervisors were not even clear on the job responsibilities that the role included. Many employees expressed concerns that certain members of management, and in particular Fastow, abused the Performance Review Committee, using it as a tool to punish those who challenged their actions. For example, employees who found themselves negotiating with LJM or LJM2 as Enron's representative often felt that Fastow used the Performance Review Committee to punish them if they tried to negotiate a good a deal for Enron at the expense of LJM or LJM2, which was in fact their role.

While incentive compensation can be a positive management tool, care must to be taken in designing incentive compensation packages to ensure that incentives are not extreme and that they do not provide incentive for employees to act unethically. For example, in the case of Enron, significant management bonuses were linked to the Performance Unit Plan and other incentive compensation packages which motivated management to manipulate financial statements in order to meet earnings targets. In it's oversight role the Board was responsible for ensuring that incentive compensation

packages for senior management were not too focused on short-term results and did not represent such a large portion of management's total compensation as to motivate management to act unethically. Given what transpired at Enron, it is clear that the Board failed in this oversight responsibility.

5.8.8 Conclusion

While identification of Control Environment weaknesses and fraud red flags is certainly not conclusive evidence that a fraud had occurred, such knowledge, certainly would have raised awareness on the part of the Board and the independent auditors with respect to the increased fraud risks. Armed with such knowledge, an effective Board would take appropriate actions to address the identified risks, such as increased monitoring of senior management's activities and increased scrutiny of proposed transactions. That being said, it is impossible to conclude how the Enron Board may have responded to such information given their apparent lack of independence from management. Likewise, one can only presume that had the independent auditors recognized the Control Environment weaknesses and related fraud risks, they would have regarded management with an increased level professional skepticism and would have responded by expanding and tailoring their audit procedures to address such risks.

In summary, an effective evaluation of the Control Environment must go beyond simply considering the policies and procedures that are documented. The Control Environment is not simply a function of management having used templates to develop glossy brochures, such as the Code of Conduct, that say the right things. The Control

Environment is a reflection of what actually happens in the organization, how business is really done. The senior executives and, in particular the CEO, play a critical role in establishing a positive corporate culture. If they are seen as simply giving lip service to the policies, such as the Code of Conduct, it is unlikely that the values and ethical standards set out in those policies will be embodied in the Control Environment of the organization. The Board, with its oversight responsibilities, also has an important role to play with respect to ensuring that management sets an appropriate tone and with respect to monitoring of senior management.

Ultimately, it is up to the CEO and the Board to ensure that senior management is seen as "walking the talk" when it comes to corporate policies. *"Official polices specify what management wants to happen. Corporate culture determines what actually happens, and which rules are obeyed, bent or ignored. Top management – starting with the CEO – plays a key role in determining the corporate culture"*[115]. The effective evaluation of the Control Environment is dependent upon the skills, knowledge and experience of the evaluator. The evaluator should possess in-depth knowledge of fraud prevention, detection and investigation in addition to the traditional understanding of internal controls over financial reporting.

[115] Committee of Sponsoring Organizations of the Treadway Commission 24

6.0 THE ROLE OF THE FORENSIC ACCOUNTANT IN ASSESSING THE CONTROL ENVIRONMENT AND ANTI-FRAUD PROGRAMS AND CONTROLS

The introduction of SOX and PCAOB Auditing Standard No. 2 placed new responsibilities on the independent auditor with respect to evaluating internal controls over financial reporting, in particular with respect to the Control Environment and Anti-Fraud Programs and Controls. The requirement that the independent auditor identify and report on material weaknesses in the Control Environment and Anti-Fraud Program and Controls, among other things, presumes that independent auditors have the knowledge, experience and training necessary to identify such weaknesses. There are a number of factors, as set out below, which lead the author to conclude that such an assumption may be overly optimistic:

independent auditors in Canada have not historically been required by the auditing standards or other regulatory requirements to perform formalized assessments of the Control Environment or Anti-Fraud Programs and Controls, and therefore have little experience in performing such assessments;

- the revised Canadian auditing standard that addresses the auditor's responsibility to consider fraud and error, set out in CICA Handbook section 5135 ("Section 5135"), only became effective for periods ending on or after December 15, 2004. The recent introduction of revised Section 5135 suggests that most independent auditors in Canada have had little experience in actually applying the recommendations in practice;

- a long history of corporate failures tied to fraudulent financial reporting provides evidence that auditors historically have not been well-equipped to identify fraud risks and red flags of fraud. While it may be true that in limited circumstance fraud by senior management is so well concealed that even experienced forensic accountants may not have identified any warning signs, experience investigating such frauds tells us that this is not generally the case. Major financial statement fraud often goes undetected due to ineffective oversight by the Board rather than as a result of having been well concealed. In fact, as was the case with Enron, there are often people in the organization, other than those complicit in the fraud, who are aware the problems;

- Insufficient time has pass since the introduction of new legislation and standards to allow the average auditor to develop the requisite knowledge and skills required to perform effective assessments of the Control Environment and Anti-Fraud Programs and Controls.

A comparison of the body of knowledge that comprises the CICA Syllabus for Entry to the Chartered Accountancy Profession (see Appendix F) to that contained in the Syllabus/Body of Knowledge of the Alliance for Excellence in Forensic Accounting (see Appendix G) demonstrates the difference in the breadth and depth of knowledge of fraud and fraud-related matters possessed by a CA·IFA compared to a typical auditor. In addition to having satisfied the educational and training requirements for entrance to

the profession of chartered accountancy, the CA·IFA has also received specialized training and experience which make them uniquely qualified to assess the Control Environment and Anti-Fraud Programs and Controls.

7.0 OVERALL CONCLUSION

SOX was enacted primarily to address the corporate failures stemming from fraudulent financial reporting and poor corporate governance. It is the author's view that the success of SOX 404 in accomplishing its objective of improved reliability of financial reporting will depend, to a large extent, on the quality of the assessments of Control Environment and Anti-Fraud Programs and Controls since these are the COSO components which can be most clearly linked to major corporate frauds, especially those involving financial statement manipulation. Given the additional training, education and experience that forensic accountants have with respect to fraud related matters, it is the author's view that these specialists would generally possess knowledge and experience that are more suited to the assessment Control Environment than generalist auditors. History has shown that auditors generally do not recognize fraud risk and red flags of fraud, as evidenced by corporate failures of public companies related to fraudulent financial reporting. Accordingly, it is the author's view that forensic accountants could contribute significantly to the improved reliability of financial reporting via their by contributing their unique skills and experience to the assessment of the Control Environment and Anti-Fraud Programs and Controls.