



dividends paid				
common shares	643	545	563	569
common share	2.21	1.76	1.76	1.76
shares outstanding at year end	290.9	290.5	310.4	322.8
total assets	91,893	113,308	131,719	129,495
total working capital(8)	\$ 863	\$ 1,482	\$ 838	\$ 939
capital expenditures	(671)	(724)	(325)	(579)
total equipment, net	5,659	5,919	5,947	5,914
total borrowings and current portion of long-term debt	13,362	14,212	14,370	14,733
total current liabilities	1,534	2,206	1,163	1,518
total assets	10,231	10,231	10,231	10,231
total liabilities	2,220	2,220	2,220	2,220
total equity	1,459	1,417	1,479	1,296
total development costs	779	784	817	922(5)
total payroll, (income taxes)	765	738	773	737
total	154	923	906	800

AUDITING AFTER SARBANES-OXLEY:

ILLUSTRATIVE CASES
BY THIBODEAU / DEBORAH FREIER

Auditing after Sarbanes-Oxley

Illustrative Cases

**Jay C. Thibodeau
Deborah Freier**



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AUDITING AFTER SARBANES-OXLEY: ILLUSTRATIVE CASES

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This book is dedicated to Ellen, my extraordinary wife of 15 years, and my children, Jenny, Eric, and Jessica. You have all provided the inspiration for me to undertake and complete this project. I could not have accomplished it without your love. Thank you.

Jay C. Thibodeau

I dedicate this book in loving memory of my father, Martin Freier, who inspired me to work hard and to strive for excellence. He also inspired me and others with his strength, his integrity, his dedication to family and friends, his desire to help others, his deep abiding love for learning, his wide array of talents and interests, and his appreciation for life. He was a great man and will truly be missed.

This book is also dedicated to Matt, who always believed in me and was a constant source of support.

Deborah Freier

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Dr. Thibodeau is the Edward F. Gibbons Research Professor at Bentley College. He received his B.S. degree from the University of Connecticut in December 1987 and his Ph.D. from the University of Connecticut in August 1996. He joined the faculty at Bentley College in September of 1996 and has worked there ever since. During his sabbatical in the Fall Semester of 2003, Jay worked with PricewaterhouseCoopers' Learning & Education group to help deliver critical knowledge about the post-Sarbanes-Oxley technical audit guidance to professionals throughout the firm. He has consulted with PricewaterhouseCoopers ever since. At Bentley College, he serves as the coordinator for all audit and assurance curriculum matters.

Dr. Thibodeau currently serves as the Chair of the National Education Committee for the American Accounting Association's Auditing Section. He has been published in *Auditing: A Journal of Practice & Theory*, *Issues in Accounting Education*, *Commercial Lending Review*, *Advances in Accounting Education*, *Asian-Pacific Journal of Accounting*, *Practical Accountant*, and *Journal of Financial Education and Managerial Auditing*. He has received national recognition for his work three times: first, for his doctoral dissertation, winning the 1996 Outstanding Doctoral Dissertation Award presented by the American Accounting Association's ABO Section; second, for curriculum innovation, winning the 2001 Joint AICPA/AAA Collaboration Award; and third, also for curricular innovation, winning the 2003 Innovation in Assurance Education Award.

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Ms. Freier is currently working as a senior analyst in the Strategy and Product Development Department at Tufts Health Plan, where she plays a key role in developing financial and competitive analyses for senior management.

Preface

After a multitude of high profile business failures and accounting restatements (Enron, WorldCom, and Qwest, to name a few) in 2001 and early 2002, Congress responded to the eroding investor confidence in audited financial statements by passing the Sarbanes-Oxley Act of 2002 (SOX). This law has required auditors to increase their audit work on internal controls systems and has forced audit firms to revamp their audit processes for publicly traded companies. The changes have been far-reaching and dramatic for both audit firms and their clients.

In the face of these sweeping regulatory changes, as well as other changes in the profession, auditing education needs to rise to the challenge of preparing audit professionals. *Auditing after Sarbanes-Oxley* presents instructors with 35 cases focusing on specific audit issues that were directly impacted by Sarbanes-Oxley, using the actual companies—Enron, WorldCom, Qwest—that have become synonymous with the capital markets' crisis in confidence. Importantly, the cases provide in-depth, up-to-date coverage of the post-Sarbanes technical audit guidance issued by the PCAOB.

Our approach to this book emphasizes the substantial benefits of using real life case examples in helping to impart knowledge related to the practice of auditing. In the education psychology literature, this type of approach has long been acknowledged as a superior manner in which to impart knowledge. In addition, there is evidence from other disciplines that the use of cases as a mechanism to impart a range of critical auditing skills, including technical skills, interpersonal relations, and ethical analysis, will be quite effective. So, by presenting the concepts of auditing using actual corporate contexts, we seek to provide readers with a real-life appreciation of these issues and clearly demonstrate the value of the Sarbanes-Oxley Act of 2002 and other changes that have been mandated by the PCAOB.

We set out to design a casebook that could be easily adopted by instructors in their classes. The cases run only three to five pages in length, which dramatically reduces the time necessary for students to grasp key learning objectives. In addition, each case focuses on a specific topic to help ensure student mastery of that topic. Our approach can be contrasted with many traditional audit cases that range from 10 to 20 pages in length and introduce multiple learning objectives concurrently.

In addition, our book has been designed to reflect an organization that closely mirrors the leading auditing and assurance textbooks. We have grouped our cases into the following categories: Ethics and Professional Responsibility; Understanding the Client's Business and Industry; Internal Control Systems; and Audits of Accounts, Processes, and Assertions. In looking over the table of contents for this book, you will note that each category has multiple cases that can be used in the classroom. This was done for two reasons. First, it allows instructors

the opportunity to illustrate the critically important auditing concepts with multiple real-life contexts, if they so choose. And second, it affords instructors with an opportunity to assign the cases on a rotating basis, if they so choose. Consider that with 35 different cases, instructors can assign 8 to 9 different cases for each of four different semesters. This will reduce the possibility of case solutions circulating around campus. Also, we have provided complete company cases to give instructors the option of presenting longer cases that focus on several issues related to a particular company.

Finally, and perhaps most important, each of our cases will contribute to students' understanding of the changes brought about by the Sarbanes-Oxley Act of 2002, a significant objective in any current undergraduate or graduate auditing course. For example, in its Auditing Standard No. 2, "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," the PCAOB has made clear that evaluating and documenting the relationship between the internal control activities and the financial statement assertions (PCAOB 2004, Paragraph #84) is instrumental in completing the audit, underscoring the importance of understanding the linkage between internal control activities, internal control objectives, and financial statement assertions. Thus, one important and explicit objective of this book is to help impart knowledge about these linkages through the use of real-life case examples.

Technical Audit Guidance

To maximize a student's knowledge acquisition of this material, this book has been designed to be read in conjunction with the post-Sarbanes-Oxley technical audit guidance. All of the post-Sarbanes-Oxley technical guidance is available for free at <http://www.pcaobus.org/Standards/index.aspx>. In addition, a summary of the Sarbanes-Oxley Act of 2002 is also available for free at http://www.aicpa.org/info/sarbanes_oxley_summary.htm.

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Section

1

Ethics and Professional Responsibility

While the Sarbanes-Oxley Act of 2002 (SOX) has had a dramatic impact on all stakeholders in the financial reporting process, arguably the most dramatic change has been that the auditing profession is now regulated. The Public Company Accounting Oversight Board (PCAOB) is now responsible for setting all auditing standards pertaining to audits of publicly traded companies. The PCAOB is also required to perform detailed inspections of audit work completed and quality control processes employed by audit firms. These changes are sure to have a dramatic impact on the auditing profession. The following cases are designed to illustrate the ethical and professional responsibility of auditors in the post-Sarbanes auditing environment.

The case readings have been developed solely as a basis for class discussion. The case readings are not intended to serve as a source of primary data or as an illustration of effective or ineffective auditing.

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Case 1.1

Enron: A Focus on Independence and Ethics

Synopsis

In its 2000 Annual Report, Enron prided itself on having “metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people.”¹ Enron’s strategy seemed to pay off. In 2000, it was the seventh largest company on the Fortune 500, with assets of \$65 billion and sales revenues of over \$100 billion.² From 1996 to 2000, Enron’s revenues had increased by more than 750 percent (over 65 percent per year), which was unprecedented in any industry.³ Yet, just a year later, Enron filed for bankruptcy, and billions of shareholder dollars and retirement savings were lost.

In 2002, Enron’s auditor Arthur Andersen LLP, one of the five largest international public accounting firms, was convicted on one charge of obstruction of justice in connection with the Enron audit. And although this conviction was overturned in 2005 by the United States Supreme Court, Andersen’s decision to destroy evidence cast suspicion on whether Andersen was trying to cover up any guilt related to a failure to perform its professional responsibilities.

Arthur Andersen

Enron paid Arthur Andersen \$46.8 million in fees for auditing, business consulting, and tax work for the fiscal year ended August 31, 1999; \$58 million in 2000; and more than \$50 million in 2001.⁴ Andersen was collecting a million

¹ Enron 2000 Annual Report, p. 7.

² Joseph F. Berardino, Remarks to U.S. House of Representatives Committee on Financial Services, December 12, 2001.

³ Bala G. Dharan and William R. Bufkins, “Red Flags in Enron’s Reporting of Revenues and Key Financial Measures,” March 2003, pre-publication draft (www.ruf.rice.edu/~bala/files/dharan-bufkins_enron_red_flags_041003.pdf), p. 4.

⁴ Anita Raghavan, “Accountable: How a Bright Star at Andersen Fell Along with Enron,” *Wall Street Journal*, May 15, 2002. Accessed from Factiva (February 25, 2005).

dollars a week from Enron in the year before its crash. Enron was one of Andersen's largest clients.

More than half of that amount was for fees that were charged for nonaudit services.⁵ In 2000, for example, Enron paid Andersen \$25 million for audit services, and \$27 million for consulting and other services, such as internal audit services.⁶

In fact, Andersen had performed Enron's internal audit function since 1993. That year, Andersen had hired 40 Enron personnel, including the vice president of internal audit, to be part of Andersen's team providing internal audit services.⁷ In 2000, as SEC chairman Arthur Levitt was trying to reform the industry practice of an audit firm also offering consulting services to their audit clients, Enron's Chairman and Chief Executive Officer Ken Lay sent a letter to Levitt (the letter was secretly coauthored by Andersen partner David Duncan), in which he wrote:

While the agreement Enron has with its independent auditors displaces a significant portion of the activities previously performed by internal resources, it is structured to ensure that Enron management maintains appropriate audit plan design, results assessment and overall monitoring and oversight responsibilities . . . Enron has found its "integrated audit" arrangement to be more efficient and cost-effective than the more traditional roles of separate internal and external auditing functions.⁸

Interestingly, at Andersen, an audit partner's compensation depended in large part on his or her ability to sell other services (in addition to auditing) to clients.⁹ Therefore, the nonaudit services provided to Enron had a big impact on the salary of the lead Andersen partner on the Enron engagement, David Duncan, who was earning around \$1 million a year.¹⁰

Close Ties between Enron and Andersen

After graduating from Texas A&M University, Duncan joined Andersen in 1981, made partner in 1995, and was named the lead partner for Enron two years later. Duncan developed a close personal relationship with Enron's Chief

⁵ Jane Mayer, "The Accountants' War," *New Yorker*, April 22, 2002. Accessed from LexisNexis Academic (February 25, 2005).

⁶ Nanette Byrnes, "Accounting in Crisis," *BusinessWeek*, January 28, 2002. Accessed from LexisNexis Academic (February 25, 2005).

⁷ Thaddeus Herrick and Alexei Barrionuevo, "Were Auditor and Client Too Close-Knit?" *Wall Street Journal*, January 21, 2002. Accessed from ProQuest Research Library (February 26, 2005).

⁸ "Letter from Kenneth Lay," Bigger than Enron transcript, Frontline, Aired on Public Broadcasting Service on June 20, 2002 (www.pbs.org/wgbh/pages/frontline/shows/regulation/congress/lay.html).

⁹ Jane Mayer, "The Accountants' War," *New Yorker*, April 22, 2002. Accessed from LexisNexis Academic (February 25, 2005).

¹⁰ Bethany McLean and Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (New York: Penguin Group, 2003), pp. 146–147.