

Arthur Andersen: An Accounting Confidence Crisis

INTRODUCTION

Arthur Andersen LLP was founded in Chicago in 1913 by Arthur Andersen and partner Clarence DeLany. Over a span of nearly 90 years, the Chicago accounting firm would become known as one of the “Big Five” largest accounting firms in the United States, together with Deloitte & Touche, PricewaterhouseCoopers, Ernst & Young, and KPMG. For most of those years, Arthur Andersen's name was synonymous with trust, integrity, and ethics. Such values are crucial for a firm charged with independently auditing and confirming the financial statements of public corporations, whose accuracy investors depend on for investment decisions.

In its earlier days, Andersen set standards for the accounting profession and advanced new initiatives on the strength of its then undeniable integrity. One example of Andersen's leadership in the profession occurred in the late 1970s when companies began acquiring IBM's new 360-mainframe computer system, the most expensive new computer technology available at the time. Many companies had been depreciating computer hardware on the basis of an assumed 10-year useful life. Andersen, under the leadership of Leonard Spacek, determined that a more realistic life span for the computers was five years. Andersen therefore advised its accounting clients to use the shorter time period for depreciation purposes, although this resulted in higher expenses charged against income and a smaller bottom line. Public corporations that failed to adopt the more conservative measure would receive an “adverse” opinion from Andersen's auditors, something they could ill afford.

Arthur Andersen once exemplified the rock-solid character and integrity that characterized the accounting profession. However, high-profile bankruptcies of clients such as Enron and WorldCom capped a string of accounting scandals that eventually cost investors nearly \$300 billion and lost jobs for hundreds of employees. As a result, the Chicago-based accounting firm closed its doors in 2002, after 90 years of business.

THE ADVENT OF CONSULTING

Leonard Spacek joined the company in 1947 following the death of founder Arthur Andersen. He was perhaps best known for his uncompromising insistence on auditor independence, which stood in stark contrast to the philosophy of combining auditing and consulting services that many firms, including Andersen itself, later adopted. Andersen began providing consulting services to large clients such as General Electric and Schlitz Brewing in the 1950s. Over the next 30 years, Andersen's consulting business became more profitable on a per-partner basis than its core accounting and tax services businesses.

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According to the American Institute of Certified Public Accountants (AICPA), the objective of an independent audit of a client's financial statements is "the expression of an opinion on the fairness with which [the financial statements] present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles." The primary responsibility of an auditor is to express an opinion on a client firm's financial statements after conducting an audit to obtain reasonable assurance that the client's financial statements are free of misstatements. It is important to note that financial statements are the responsibility of a company's management and not the outside auditor.

However, at Andersen growth became the highest priority, and its emphasis on recruiting and retaining big clients might have come at the expense of quality and independent audits. The company linked its consulting business in a joint cooperative relationship with its audit arm, which compromised its auditors' independence, a quality crucial to the execution of a credible audit. The firm's focus on growth also generated a fundamental change in its corporate culture, one in which obtaining high-profit consulting business seems to have been regarded more highly than providing objective auditing services. Those individuals who could deliver the big accounts were often promoted before those people who were concerned with conducting quality audits.

Andersen's consulting business became recognized as one of the fastest-growing and most profitable consulting networks in the world. Revenues from consulting surpassed the auditing unit for the first time in 1984. Although Andersen's consulting business was growing at a rapid pace, its audit practice remained the company's bread and butter. Ten years later, Arthur Andersen merged its operational and business systems consulting units and set up a separate business consulting practice in order to offer clients a broader range of integrated services. Throughout the 1990s, Andersen reaped huge profits by selling consulting services to many clients whose financial statements it also audited. This lucrative full-service strategy would later pose an ethical conflict-of-interest dilemma for some Andersen partners, who had to decide how to treat questionable accounting practices discovered at some of Andersen's largest clients.

Thanks to the growth of Andersen's consulting services, many viewed it as a successful model that other large accounting firms should emulate. However, this same model eventually raised alarm bells at the Securities and Exchange Commission (SEC), concerned over its potential for compromising the independence of audits. In 1998, then-SEC chairman Arthur Levitt publicly voiced these concerns and recommended new rules that would restrict the non-audit services that accounting firms could provide to their audit clients—a suggestion that Andersen vehemently opposed.

Nonetheless, in 1999 Andersen chose to split its accounting and consulting functions into two separate—and often competing—units. Reportedly, under this arrangement, competition between the two units for accounts tended to discourage a team spirit and instead fostered secrecy and self-interestedness. Communication suffered, hampering the firm's ability to respond quickly and effectively to crises. As revenues grew, the consulting unit demanded greater compensation and recognition. Infighting between the consulting and auditing units grew until the company was essentially split into two opposing factions.

In August 2000, following an arbitration hearing, a judge ruled that Andersen's consulting arm could effectively divorce the accounting firm and operate independently. By that time, Andersen's consulting business consisted of about 11,000 consultants and brought in global revenues of nearly \$2 billion. Arthur Andersen, as a whole, employed more than 85,000 people worldwide. The new consulting company promptly changed its name to Accenture the following January. The court later ordered Arthur Andersen to change its name to Andersen Worldwide in order to better represent its new global brand of accounting services.

Meanwhile, in January 2001, Andersen named Joseph Berardino as the new CEO of the U.S. audit practice. His first task was to navigate the smaller company through a number of lawsuits that had developed in prior years. The company paid \$110 million in May 2001 to settle claims brought by Sunbeam shareholders for accounting irregularities and \$100 million to settle with Waste Management shareholders over similar charges a month later. In the meantime, news that Enron had overstated earnings became public, sending shock waves through the financial markets. Over the following year, many companies, a number of them Andersen clients, were forced to restate earnings. The following sections describe a few of the cases that helped lead to Andersen's collapse.

BAPTIST FOUNDATION OF ARIZONA

In what would become the largest bankruptcy of a nonprofit charity in U.S history, the Baptist Foundation of Arizona (BFA), which Andersen served as auditor, lost \$570 million of donor funds. BFA, an agency of the Arizona Southern Baptist Convention, was founded in 1948 to raise and manage endowments for church work in Arizona. It operated like a bank, paying interest on deposits that were used mostly to invest in Arizona real estate. The foundation also offered estate and financial planning services to the state's more than 400 Southern Baptist churches and was one of the few foundations to offer investments to individuals.

BFA invested heavily in real estate, a more speculative investment strategy than other Baptist foundations in the state traditionally used. Profits from investments were supposed to be used to fund the churches' ministries and numerous charitable causes. Problems began when the real estate market in Arizona suffered a downturn, and BFA's management came under pressure to show a profit. To do so, foundation officials allegedly concealed losses from investors beginning in 1986 by selling some properties at inflated prices to entities that had borrowed money from the foundation and were unlikely to pay for the properties unless the real estate market turned around. In what court documents would later dub a Ponzi scheme, foundation officials allegedly took money from new investors to pay off existing investors in order to keep cash flowing. All the while, the foundation's top officers continued to receive six-figure salaries. With obligations to investors mounting, the scheme eventually unraveled, leading to criminal investigations and investor lawsuits against BFA and Andersen; more than half of the foundation's 133 employees were laid off. Finally, the foundation petitioned for Chapter 11 bankruptcy protection in 1999, listing debts of about \$640 million against assets of about \$240 million.

The investor lawsuit against Andersen accused the auditing firm of issuing false and misleading approvals of BFA's financial statements, which allowed the foundation to perpetuate the fraud. Andersen, in a February 2000 statement, responded that it sympathized with BFA investors but stood by the accuracy of its audit opinions. The firm blamed BFA

management for the collapse, arguing that it was given misleading information on which to conduct the audits. However, during nearly two years of investigation, reports surfaced that Andersen had been warned of possible fraudulent activity, and the firm eventually agreed to pay \$217 million to settle the shareholder lawsuit in 2002.

SUNBEAM

Andersen's troubles over Sunbeam Corp. began when its audits failed to address serious accounting errors that eventually led to a class-action lawsuit by Sunbeam investors and the ouster of CEO Albert Dunlap in 1998. Boca Raton-based Sunbeam was the maker of such home appliance brands as Mr. Coffee, Mixmaster, Oster, Powermate, and others. Both the lawsuit and a civil injunction filed by the SEC accused Sunbeam of inflating earnings through fraudulent accounting strategies such as "cookie jar" revenues, recording revenue on contingent sales, and accelerating sales from later periods into the present quarter. The company was also accused of using improper "bill and hold" transactions, which involves booking sales months ahead of actual shipment or billing, temporarily inflating revenue through accounts receivable, and artificially boosting quarterly net income. As a result, Sunbeam was forced to restate six quarters of financial statements. The SEC's injunction also accused Phillip Harlow, then a partner at Arthur Andersen, of authorizing clean or "unqualified" opinions on Sunbeam's 1996 and 1997 financial statements despite his awareness of many of Sunbeam's accounting and disclosure improprieties.

In 2002, a federal judge approved a \$141 million settlement in the case. In it, Andersen agreed to pay \$110 million to resolve the claims without admitting fault or liability. Losses to Sunbeam shareholders amounted to about \$4.4 billion, with job losses of about 1,700.

WASTE MANAGEMENT

Andersen also found itself in court over questionable accounting practices with regard to \$1.4 billion of overstated earnings at Waste Management. A complaint filed by the SEC charged Waste Management with perpetrating a "massive" financial fraud over a period of more than five years. According to the complaint, the company's senior management aided and abetted others' violations of antifraud, reporting, and record keeping provisions of federal securities laws, resulting in a loss to investors of more than \$6 billion. Andersen was named in the case as having assisted in the fraud by repeatedly issuing unqualified audit opinions on Waste Management's materially misleading financial statements.

According to SEC documents, Waste Management capped the amount of fees it would pay for Andersen's auditing services, but it advised Andersen that it could earn additional fees through "special work." At first, Andersen identified improper accounting practices and presented them to Waste Management officials in a report called "Proposed Adjusting Journal Entries," which outlined entries that needed to be corrected to avoid understating Waste Management's expenses and overstating its earnings. However, Waste officials refused to make the corrections, and instead allegedly entered into a closed-door agreement with Andersen to write off the accumulated errors over a 10-year period and change its underlying accounting practices, but only in future periods. The SEC viewed this agreement as an attempt to cover up past frauds and to commit future frauds.

The result of these cases was that Andersen paid some \$220 million to Waste Management shareholders and \$7 million to the SEC. Four Andersen partners were sanctioned, and an injunction was obtained against the firm. Andersen, as part of its consent decree, was forced to promise not to sign off on spurious financial statements in the future or it would face disbarment from practicing before the SEC—a promise that it would later break with Enron. After the dust settled, Waste Management shareholders lost about \$20.5 billion and about 11,000 employees were laid off.

ENRON

In October 2001, the Securities and Exchange Commission announced that it was launching an investigation into the accounting of Enron, one of Andersen's biggest clients. Indeed, Andersen's new CEO, Joseph Berardino, had perhaps viewed the \$1 million a week in audit fees Enron paid to Andersen, along with the consulting fees it paid to Andersen's spin-off firm, Accenture, as a significant opportunity to expand revenues at Andersen. Plus, with Enron as a client, Andersen had been able to make 80 percent of the companies in the oil and gas industry its clients. However, on November 8, 2001, Enron was forced to restate five years' worth of financial statements that Andersen had signed off on, accounting for \$586 million in losses. Within a month, Enron had filed for bankruptcy. The U.S. Justice Department began a criminal investigation into Andersen in January 2002, prompting both Andersen's clients and its employees to jump ship. The auditing firm eventually admitted to destroying a number of documents concerning its auditing of Enron, which led to an indictment for obstruction of justice on March 14, 2002. CEO Bernardino stepped down by the end of the month.

As Andersen's obstruction-of-justice trial progressed, Nancy Temple, Andersen's Chicagobased lawyer, demanded Fifth Amendment protection and thus did not have to testify. Many others named her as the "corrupt persuader" who led others astray. She allegedly instructed David Duncan, Andersen's supervisor of the Enron account, to remove her name from memos that could have incriminated her. On June 15, 2002, the jury found Andersen guilty of obstruction of justice, the first accounting firm ever to be convicted of a felony. The company agreed to stop auditing public companies by August 31, 2002, essentially shutting down the business.

TROUBLE WITH TELECOMS

Unfortunately for Andersen, the accusations of accounting fraud did not end with Enron. News soon surfaced that WorldCom, Andersen's largest client, had improperly accounted for nearly \$3.9 billion of expenses and had overstated earnings in 2001 and the first part of 2002. Later investigations revealed that WorldCom's total fraudulent activities amounted to over \$75 billion. After WorldCom restated its earnings, its stock price plummeted, and investors launched a barrage of lawsuits that sent the telecom into bankruptcy court. WorldCom's bankruptcy filing eclipsed Enron's as the second largest in U.S. history (six years later, Lehman Brothers would top WorldCom when it filed for bankruptcy at the onset of the 2008-2009 financial crisis). Andersen blamed WorldCom for the scandal, insisting that the expense irregularities had not been disclosed to its auditors and that it had complied with SEC standards in its auditing of WorldCom. WorldCom, however, pointed the finger of blame not only at its former managers but also at Andersen for failing to find the accounting irregularities. The SEC filed fraud charges against WorldCom, which fired its CFO.

While the Enron and WorldCom scandals continued, more telecommunications firms, including Global Crossing and Qwest Communications, came under investigation for alleged accounting improprieties. At the heart of both cases is the issue of fake asset swaps, in which the accused telecom companies allegedly exchanged fiber-optic broadband capacity at inflated prices in order to show huge gains. An investor lawsuit was filed against Global Crossing and Andersen, alleging that Global Crossing had artificially inflated earnings and that Andersen had violated federal securities laws by issuing unqualified (positive) audit opinions on Global Crossing's financial statements, though it knew or failed to discover that they contained material misstatements. Global Crossing filed for Chapter 11 bankruptcy protection and fired Andersen as its auditor. Qwest, which avoided bankruptcy court, admitted to using improper accounting methods and was forced to restate profits for 1999, 2000, and 2001, including \$950 million in relation to the swaps and up to \$531 million in cash sales of optical capacity.

CORPORATE CULTURE AND ETHICAL RAMIFICATIONS

As the details of these investigations into accounting irregularities and fraud came to light, it became apparent that Andersen was more concerned about its own revenue growth rather than where the revenue came from or whether its independence as an auditor had been compromised. One of the reasons for this confusion in its corporate culture may have been that numerous inexperienced business consultants and untrained auditors were sent to client sites who were largely ignorant of company policies. Another factor may have been its partners' limited involvement in the process of issuing opinions. As the company grew, the number of partners stagnated. There is also evidence that Andersen had limited oversight over its audit teams and that such visibility was impaired by a relative lack of checks and balances that could have identified when audit teams had strayed from accepted policies. Audit teams had great discretion in terms of issuing financials and restatements.

The problem also appears to be Arthur Andersen's corporate culture. As the years went on, the company strayed from the high ideals set forth by company founder Arthur Andersen. According to former employees, the corporate culture had become highly competitive. Employees were rewarded for the amount of money they brought into the company rather than for acting with integrity. In some cases, it appeared that Arthur Andersen may have even taken action to discourage employees from raising the red flag regarding questionable accounting practices. Evidence during the proceedings revealed that as early as 1999, Andersen auditor Carl Bass expressed concern over Enron's use of derivatives and off-the-balance-sheet partnerships. A senior executive allegedly removed Bass from the Enron account due to his complaints. By the time Arthur Andersen made a wide-scale effort at reform, it was too late to save the company.

In February 2002, Andersen hired former Federal Reserve Board chairman Paul Volcker to institute reform and to help restore its reputation. Soon after Volcker came on board, however, Andersen was indicted for obstruction of justice in connection with the shredding of Enron documents. During the investigations, Andersen had been trying to negotiate merger deals for its international partnerships and salvage what was left of its U.S. operations. However, amid a mass exodus of clients and partners and the resignation of Bernardino, the company was forced to begin selling off various business units, and ultimately laid off more than 7,000 employees in the United States.

During this time, Alaska Air Group, an Andersen client, restated its 2001 results, which resulted in an *increase* in shareholder equity of \$31 million. Alaska Air made the restatement on the recommendation of its new auditor, Deloitte and Touche, which had replaced Andersen in May 2002.

After Andersen was convicted of obstruction of justice, it was fined \$500,000, among other penalties. Andersen agreed to cease auditing public corporations by the end of August 2002. Accenture, its spin-off consulting unit, is free and clear of all charges, although the consulting firm remains reluctant to mention its origins and association with Andersen: nowhere on Accenture's website is the word *Andersen* to be found.

In 2005, the Supreme Court threw out Arthur Andersen's obstruction of justice conviction. A federal jury found Andersen guilty of obstructing justice by "corruptly persuading" workers to shred documents related to alleged improprieties by Enron. However, the Supreme Court said the jury instructions diluted the meaning of "corruptly" to the point that it could have covered the type of innocent shredding that companies do each day. The Supreme Court did not rule on whether Andersen's shredding was wrong; rather, the case revolved entirely around the adequacy of the jury instructions at the company's trial.

While some experts believe that the Supreme Court's ruling was strictly based on technical issues rather than whether Andersen was guilty of obstruction of justice, the fact remains that Andersen may not have gone out of business if this ruling had been made available during the trial. Looking back at this event, accounting consultants and many business executives believe that the quick rush to destroy Arthur Andersen's accounting and auditing business may have had a negative effect on competition and the cost of auditing for all public corporations. On the other hand, Arthur Andersen's involvement with so many accounting fraud cases could have caused regulatory agencies to overreact. Politician Michael Oxley, who was the house sponsor of the Sarbanes-Oxley Act in 2002, later claimed that Arthur Andersen did not have to go out of business and that its large size made its death devastating. The lives of many thousands of Arthur Andersen employees not involved in accounting fraud were affected by all of the events associated with this case.

On the other hand, not all employees have given up on the Andersen name. In 2014 former Andersen employees decided to buy the rights to the name. They believe the name still has credibility and changed the name of their tax-consulting firm from Wealth & Tax Advisory Services to Andersen Tax. However, it is unlikely that the Andersen name will ever be completely restored to its former glory.

IMPLICATIONS FOR REGULATION AND ACCOUNTING ETHICS

The string of accounting scandals of the early twenty-first century sent many Andersen clients into bankruptcy court and subjected even more to greater scrutiny. They also helped spur a new focus on business ethics, driven largely by public demands for greater corporate transparency and accountability. In response, Congress passed the Sarbanes-Oxley Act of 2002, which established new guidelines and direction for corporate and accounting responsibility. The act was enacted to combat securities and accounting fraud and includes, among other things, provisions for a new accounting oversight board, stiffer penalties for

violators, and higher standards of corporate governance. Table 1 discusses some of the components of the act.

For the accounting profession, Sarbanes–Oxley emphasizes auditor independence and quality, restricts accounting firms’ ability to provide both audit and non-audit services for the same clients, and requires periodic reviews of audit firms. All are provisions that the Arthur Andersen of the past would likely have supported wholeheartedly. Some were concerned, however, that such sweeping legislative and regulatory reform may be occurring too quickly in response to intense public and political pressure. The worry is that these reforms may not have been given enough forethought and cost-benefit consideration for those public corporations that operate within the law, which comprise the vast majority of corporate America. Studies conducted after the passage of Sarbanes-Oxley indicated that the number of public companies going private jumped 30 percent in a 16-month period, and the number of private companies choosing to go public hit an eight-year low in 2003. Although there may be different reasons for this trend, smaller businesses have cited the cost of compliance that Sarbanes-Oxley imposes on public companies as one of the considerations in privatization.

TABLE 1 Sarbanes–Oxley Act Intended to Prevent Accounting Misconduct

SARBANES–OXLEY ACT	WHAT DOES WILL DO	WHAT DOES IT PREVENT
Section 104: Inspection of Registered Public Accounting Firms	Verify that financial statements are accurate	Use of questionable/illegal accounting practices
Section 201: Services Outside the Scope of Auditors; Prohibited Activities	Restrict auditors to audit activities only	Improper relationships, reduce likelihood of compromising good audit for more revenue
Section 203: Audit Partner Rotation	Rotate partners assigned to client, so fresh eyes see work papers	“Partner in Crime” relationship
Section 204: Auditor Reports to Audit Committees	Auditors must report to committee, who work for the board, not the company	Powerlessness of auditors by giving board power to investigate and rectify

		Companies from publishing misleading statements
Section 303: Improper Influence on Conduct of Audits	Removes power from company personnel	Withholding of information from auditors by making this illegal
Section 404: Management Assessment of Internal Controls	Gives auditor a voice outside of the audit to attest to policies demonstrated by the company	Information slipping by the SEC and stakeholders by giving more visibility to the firm
Title VIII: Corporate and Criminal Fraud Accountability Act of 2002	Makes it a felony to impede federal investigation, provides whistle-blower protection	Destruction of documents, will allow investigators to review work of auditors
Section 1102: Tampering with a Record or Otherwise Impeding an Official Proceeding	Persons acting to corrupt evidence liable for extended prison term	Others from attempting to interfere in an official investigation

SOURCE: Table adapted from Mandy Storeim, *Andersen LLP: An Assessment of the Company's Dilemmas in Corporate Crisis*, BG660 Final Project, Colorado State University, November 13, 2002.

THE ACCOUNTING FIELD TODAY

Arthur Andersen is the perfect example of how a company that appeared impenetrable to failure can be destroyed. Despite being touted as a hero among accounting professionals for his early recognition of the problems at Enron, in 2010 Carl Bass had his CPA license revoked—along with another former auditor of Enron—by the Texas State Board of Public Accountancy. The board claimed that the two men did not follow accepted accounting practices in their 1997 and 1998 Enron audits. The pair challenged the decision in court. Although it has been nearly a decade since the disaster, the scandal still resonates with lawmakers.

There is also much debate over whether the Arthur Andersen/Enron scandal actually changed anything. Although regulators were hopeful that Sarbanes-Oxley would prevent similar scandals in the future, it did not prevent the 2008-2009 financial meltdown. Several

financial institutions used accounting and financial tricks to inflate earnings and engage in risky financial practices. For instance, much like Enron used off-the-balance-sheet partnerships to inflate earnings, Lehman Brothers used repurchase agreements (repos) to make the company look more profitable than it really was. Like Enron, Lehman Brothers was forced to declare bankruptcy.

As a result of the financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act was passed in 2010. Among its provisions were greater regulation and oversight of the banking industry, break ups of financial institutions considered “too big to fail,” and the creation of a Consumer Financial Protection Bureau to help protect consumers from complex and deceptive financial instruments.

Accounting firms did not escape unscathed from the financial crisis. If anything, the misconduct at Arthur Andersen has increased the scrutiny that accounting firms face when such misconduct occurs. In 2010 New York's former attorney general Andrew Cuomo filed a lawsuit against accounting firm Ernst & Young, one of the "Big Four," for aiding Lehman Brothers in covering up fraud. According to the allegation, Ernst & Young signed off on Lehman Brothers' repo transactions, which helped the company to move debt off of its balance sheets. Ernst & Young eventually settled the lawsuit for \$10 million.

The financial crisis seriously undermined consumers' trust in business, leading some to speculate that regulation like Sarbanes-Oxley had failed. Others, however, believe that Sarbanes-Oxley prevented the financial meltdown from being much worse. They argue that these tougher accounting regulations prevented the wide-scale misconduct that occurred in the finance industry from occurring in accounting. It is clear that the impact which Arthur Andersen has had on accounting is far from over. Rather, it serves as a continual reminder to both regulators and accounting firms of the importance of corporate governance, integrity, and a strong corporate culture within the accounting field.

QUESTIONS

1. Describe the legal and ethical issues surrounding Andersen's auditing of companies accused of accounting improprieties.
2. What evidence is there that Andersen's corporate culture contributed to its downfall?
3. How can the provisions of the Sarbanes-Oxley Act help minimize the likelihood of auditors failing to identify accounting irregularities?

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