CASE 7

Arthur Andersen: Questionable Accounting Practices

Arthur Andersen and partner Clarence DeLany founded Arthur Andersen LLP in Chicago in 1913. Over a span of nearly ninety 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, the firm's name was nearly 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 ten-year useful life. Andersen, under the leadership of Leonard Spacek, determined that a more realistic life span for the machines 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 was synonymous with the accounting profession. But high-profile bankruptcies of clients such as Enron and WorldCom capped a string of accounting scandals that eventually cost investors nearly $300 billion and hundreds of thousands of people their jobs. As a result, the Chicago-based accounting firm was forced to close its doors after ninety years of business.

We appreciate the work of Heather Stein, Colorado State University, in helping draft the previous edition of this case. This case was prepared for classroom discussion rather than to illustrate either effective or ineffective handling of an administrative, ethical, or legal decision by management. All sources used for this case were obtained through publicly available material.

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 was 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 thirty years, Andersen's consulting business became more profitable per partner than its core accounting and tax services businesses.

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 material misstatement. It is important to note that financial statements are the responsibility of a company's management and not the outside auditor.

At Andersen, growth became the priority, and its emphasis on recruiting and retaining big clients perhaps came 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 ahead of the practitioners of 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 began catching up with the auditing unit in the early 1980s and surpassed it 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 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 nonaudit 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 function 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 selfishness. 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 eleven thousand consultants and brought in global revenues of nearly $2 billion. Arthur Andersen as a whole employed more than eighty-five thousand 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. auditing 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.

THE COLLAPSE OF ANDERSEN

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, bilked investors out of about $570 million. 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 four hundred 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 label a "Ponzi scheme" after a famous swindling case, foundation officials allegedly took money from new investors to pay off existing investors in order to keep cash flowing. In the meantime, the foundation's top officers received 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 by some BFA employees, and the firm eventually agreed to pay $217 million to settle the shareholder lawsuit in May 2002.

Sunbeam

Andersen's troubles over Sunbeam Corporation 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 is the maker of such notable 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. On February 6, 2001, Sunbeam Corporation filed a voluntary petition with the U.S. Bankruptcy Court for the Southern District of New York under Chapter 11 of Title 11 of the Bankruptcy Code. In August 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. Sunbeam's losses to shareholders amounted to over $4.4 billion and seventeen hundred lost jobs. In 2002 Sunbeam Corporation successfully emerged from

bankruptcy protection as a private company and new identity—American Household, Inc. (AHI). Its former household products division became the subsidiary Sunbeam Products, Inc. In 2005 AHI was sold to Jarden Consumer Solutions, a wholly owned subsidiary of Jarden Corporation.

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 itself violated and 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 aided 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 ten-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 eleven thousand employees were laid off. In 2001 Waste Management agreed to pay out $457 million for a class-action lawsuit related to Andersen.

Enron

In October 2001, the SEC 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. And, 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 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 Berardino stepped down by the end of the month.

As Andersen's obstruction-of-justice trial progressed, Nancy Temple, Andersen's Chicago-based 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.

Telecommunication Firms

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. After WorldCom restated its earnings, its stock price plummeted, and investors launched a barrage of lawsuits that sent WorldCom into bankruptcy court. WorldCom's bankruptcy filing eclipsed Enron's as the largest in U.S. history. 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. Both firms had been issued unqualified or clean opinions on audits by Andersen. At the heart of both cases is the issue of fake asset swaps, in which the accused telecommunication 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 they contained material misstatements. Global Crossing filed for Chapter 11 bankruptcy protection and fired Andersen as its auditor. Qwest, which thus far has avoided bankruptcy court, admitted to using improper accounting methods and will likely be forced to restate profits for 1999 through 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 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 that 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 financial statements and restatements.

In February 2002, Andersen hired former Federal Reserve Board chairman Paul Volcker to institute reform and 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. But amid a mass exodus of clients and partners and Berardino's resignation, the company was forced to begin selling off various business units and ultimately laid off more than seven thousand 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 & 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, essentially marking the end of the ninety-year-old accounting institution. Accenture, its spin-off consulting unit, is free and clear of all charges although the consulting firm seems reluctant to mention its origins and association with Andersen: Nowhere on Accenture's website is the word *Andersen* to be found.

In 2005 the U.S. 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. But 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 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.

Although some experts believe that the Court's ruling was strictly based on technical issues rather than whether or not 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 caused what could have been an overreaction by regulatory entities. Unfortunately for many thousands of Arthur Andersen employees who were not involved in accounting fraud, their lives were affected by all of the events associated with this case.

IMPLICATIONS FOR REGULATION AND ACCOUNTING ETHICS

The 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

TABLE C7–1 Intentions of the Sarbanes–Oxley Act

Sarbanes–Oxley Act	What It Will Do	What It Could Prevent
Section 104: Inspection of Registered Public Accounting Firms	Verify that financial statements are accurate	Using questionable/illegal accounting practices
Section 201: Services Outside the Scope of Auditors; Prohibited Activities	Restrict auditors to audit activities only	Fostering improper relationships; reducing the likelihood of compromising a good audit for more revenue
Section 203: Audit Partner Rotation	Rotate partners assigned to client so that "fresh eyes" see paperwork	Fostering "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 the board power to investigate and rectify
Section 302: Corporate Responsibility for Financial Reports	Making CEOs personally liable for ensuring that statements are reported accurately	Publishing misleading statements
Section 303: Improper Influence on Conduct of Audits	Removes power from company personnel	Withholding 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; allows investigators to review work of auditors	Destruction of documents
Section 1102: Tampering with a Record or Otherwise Impeding an Official Proceeding	Persons acting to corrupt or destroy 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.

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 C7–1 discusses some of the components of the act and how it could prevent these types of situations from occurring again.

For the accounting profession, the Sarbanes–Oxley Act emphasizes auditor independence and quality, restricts accounting firms' ability to provide both audit and nonaudit 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 are 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.

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?

SOURCES: "$141M Sunbeam Fraud Case Settled; Andersen to Pay Bulk," New York State Society of Certified Public Accountants, August 9, 2002, http://nysscpa.org/home/2002/802/1week/article58.htm; "Alaska Air Restatement Adds Shareholder Value," *Seattle Times,* January 11, 2003, C1; "Andersen's Fall from Grace," BBC News online, June 17, 2002, www.news.bbc.co.uk/1/hi/business/2049237.stm; Joan Biskupic, "Ruling: Instructions to Jury Were Flawed," *USA Today* online, June, 1, 2005, http://www.keepmedia.com/pubs/USATODAY/2005/06/01/875172; John A. Byrne, "Fall from Grace," *BusinessWeek,* August 12, 2002, 50–56; Nanette Byrnes, Mike McNamee, Diane Brady, Louis Lavelle, Christopher Palmeri, et al., "Accounting in Crisis," *BusinessWeek,* January 28, 2002, 44–48; Dave Carpenter, "Andersen's WorldCom Story Familiar to Enron Excuse," *Houston Chronicle* online, June 27, 2002, www.chron.com/cs/CDA/printstory.hts/special/andersen/1474232; "The Fall of Andersen," *Chicago Tribune* online, September 1, 2002, www.chicagotribune.com/business/showcase/chi-0209010315sep01.story; Greg Farrell, "Jury Will Hear of Andersen's Past Scandals," *USA Today* online, May 8, 2003, www.usatoday.com/money/energy/enron/2002-05-07-andersen-trial.htm; "First Trial of Arizona Baptist Foundation Case Starts This Week," *Baptist Standard* online, March 4, 2002, http://baptiststandard.com/2002/3_4/print/arizona.html; Jonathan D. Glater, "Auditor to Pay $217 Million to Settle Suits," Yahoo! News, March 2, 2002, http://premium.news.yahoo.com/news?tmpl=story&u=/nytp/20020302/880914; "Global Crossing Drops Andersen; Being Investigated by FBI, SEC," New York State Society of Certified Public Accountants, February 2, 2002, www.nysscpa.org/home/2002/202/1week/article45.htm; Floyd Norris, "$217 Million New Settlement by Andersen in Baptist Case," Yahoo! News, May 7, 2002, http://premium.news.yahoo.com/news?tmpl=story&u=/nytp/20020507/918059; Bruce Nussbaum, "Can You Trust Anybody Anymore?" *BusinessWeek,* January 28, 2002, 31–32; Barbara Powell, "Bankrupt WorldCom Says Financial Woes Persisting," Yahoo! News, October 22, 2002, http://story.news.yahoo.com/news?tmpl=story&u=/ap/20021022/ap_wo_en_po/

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