

A SAD TALE: The Demise of Arthur Andersen

In January 2002, there were five major public accounting firms: Arthur Andersen, Deloitte Touche, KPMG, PricewaterhouseCoopers, and Ernst & Young. By late fall of that year, the number had been reduced to four. Arthur Andersen became the first major public accounting firm to be found guilty of a felony (a conviction later overturned), and as a result it virtually ceased to exist.

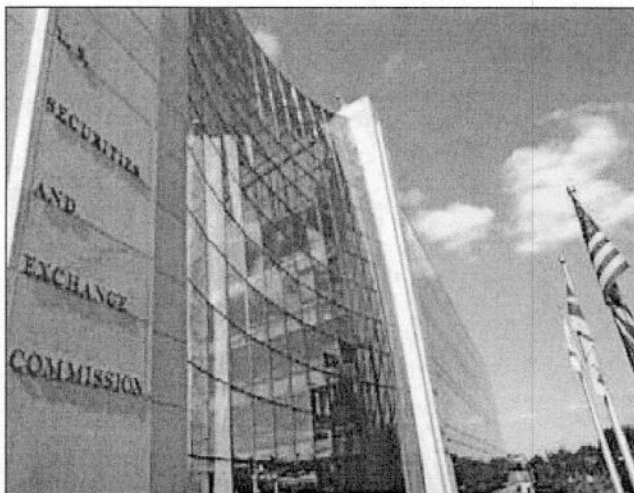
That such a fate could befall Andersen is especially sad given its early history. When Andersen and Company was established in 1918, it was led by Arthur Andersen, an acknowledged man of principle, and the company had a credo that became firmly embedded in the culture: "Think Straight and Talk Straight." Andersen became an industry leader partly on the basis of high ethical principles and integrity.

How did a one-time industry leader find itself in a position where it received a corporate death penalty over ethical issues? First, the market changed. During the 1980s, a boom in mergers and acquisitions and the emergence of information technology fueled the growth of an extremely profitable consulting practice at Andersen. The profits from consulting contracts soon exceeded the profits from auditing, Andersen's core business. Many of the consulting clients were also audit clients, and the firm found that the audit relationship was an ideal bridge for selling consulting services. Soon the audit fees became "loss leaders" to win audits, which allowed the consultants to sell more lucrative consulting contracts.

Tension between Audit and Consulting

At Andersen, tension between audit and consulting partners broke into open and sometimes public warfare. At the heart of the problem was how to divide up the earnings from the consulting practice among the two groups. The resulting conflict ended in divorce, with the consultants leaving to form their own firm. The firm, Accenture, continues to thrive today.

Once the firm split in two, Andersen began to rebuild a consulting practice as part of the accounting practice. Consulting continued to be a highly profitable business, and audit partners were now asked to sell consulting services to other clients, a role that many auditors found uncomfortable.



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Although the accountants were firmly in charge, the role of partners as salespersons compounded an already existing ethical issue—that of conflict of interest. It is legally well established that the fiduciary responsibility of a certified public accounting (CPA) firm is to the investors and creditors of the firm being audited. CPA firms are supposed to render an opinion as to whether a firm's financial statements are reasonably accurate and whether the firm has applied gener-

ally accepted accounting principles in a consistent manner over time so as not to distort the financial statements. To meet their fiduciary responsibilities, auditors must maintain independence from the firms they audit.

What might interfere with the objective judgment of the public accounting firms? One problem arises because it is the audited companies themselves that pay the auditors' fees. Auditors might not be completely objective when auditing a firm because they fear losing consulting business. This is an issue that regulators and auditors have not yet solved. But another problem arises in situations where accounting firms provide consulting services to the companies they audit. Although all of the major accounting firms were involved in this practice to some extent, Andersen had developed an aggressive culture for engaging partners to sell consulting services to audit clients.

Andersen's Problems Mount

The unraveling of Andersen began in the 1990s with a series of accounting scandals at Sunbeam, Waste Management, and Colonial Realty—all firms that Andersen had audited. But scandals involving the energy giant Enron proved to be the firm's undoing. The account was huge. In 2000 alone, Andersen received \$52 million in fees from Enron, approximately 50 percent for auditing and 50 percent for other consulting services, especially tax services. The partner in charge of the account and his entire 100-person team worked out of Enron's Houston office. Approximately 300 of Enron's senior and middle managers had been Andersen employees.

Enron went bankrupt in December 2001 after large-scale accounting irregularities came to light, prompting an investigation by the Securities and Exchange Commission

(SEC). It soon became clear that Enron's financial statements for some time had been largely the products of accounting fraud, showing the company to be in far better financial condition than was actually the case. The inevitable question was asked: Why hadn't the auditors called attention to Enron's questionable accounting practices? The answer was a simple one. Andersen had major conflicts of interest. Indeed, when one member of Andersen's Professional Standards Group objected to some of Enron's accounting practices, Andersen removed him from auditing responsibilities at Enron—in response to a request from Enron management.

Playing Hardball and Losing

The SEC was determined to make an example of Andersen. The Justice Department began a criminal investigation, but investigators were willing to explore some "settlement options" in return for Andersen's cooperation. However, Andersen's senior management appeared arrogant and failed to grasp the political mood in Congress and in the country after a series of business scandals that had brought more than one large company to bankruptcy.

After several months of sparring with the Andersen senior management team, the Justice Department charged Andersen with a felony offense—obstruction of justice. Andersen was found guilty in 2002 of illegally instructing its employees to destroy documents relating to Enron, even as the government was conducting inquiries into Enron's finances. During the trial, government lawyers argued that by instructing its staff to "undertake an unprecedented cam-

paign of document destruction," Andersen had obstructed the government's investigation.

Since a firm convicted of a felony cannot audit a publicly held company, the conviction spelled the end for Andersen. But even before the guilty verdict, there had been a massive defection of Andersen clients to other accounting firms. The evidence presented at trial showed a breakdown in Andersen's internal controls, a lack of leadership, and an environment in Andersen's Houston office that fostered recklessness and unethical behavior by some partners. In 2005, the United States Supreme Court unanimously overturned the Andersen conviction on the grounds that the jury was given overly broad instructions by the federal judge who presided over the case. But by then it was too late. Most of the Andersen partners had either retired or gone to work for former competitors, and the company had all but ceased to exist.

DISCUSSION QUESTIONS

1. To what extent do market pressures encourage unethical behavior? Can the demise of Andersen be blamed on the fact that the market began rewarding consulting services of the kind Andersen could provide?
2. How serious are the kinds of conflicts of interest discussed in this case? Did Sarbanes-Oxley eliminate the most serious conflicts?
3. Was it fair for the government to destroy an entire company because of the misdeeds of some of its members, or had Andersen become such a serious offender that such an action on the part of the government was justified?

Discuss the mistakes made by Arthur Andersen and potential actions that leadership could have taken to prevent the organizational failure.

(350 words with 2 reference)