Arthur Andersen (A): The Waste Management Crisis

Background

Arthur Andersen had long set the industry standard for professionalism in external accounting. In its own eyes, the firm stood for public service and independent integrity; it was committed to protecting shareholder interests and even saw itself as a guardian of public trust. Andersen employees often spent their entire careers at the firm, where the corporate culture was strong and uniform and was supported by a rigorous system of education and acculturation into the firm's values. In the early years, the partners knew each other—governing "face to face"—and they largely agreed on the standards the firm needed to maintain. However, as the company experienced explosive growth and its mode of governance evolved, the culture and standards began to weaken.

The Founding Father

Born in 1885 to a family of Norwegian immigrants, Arthur E. Andersen made his way in the world through "strong values and hard work." 7 In 1913, while he was working as a professor at Northwestern University, he and a partner took over the company that came to bear his name. In an era when accounting standards were in flux, the firm distinguished itself for its willingness to tell the unvarnished truth. Rather than bend to a client's demands, Arthur E. Andersen was prepared to lose an account in order to avoid compromising his firm's standards. In one famous incident that became a staple in company lore, the president of a large client company barged into Andersen headquarters and demanded an audit certification on his own terms—flatly contradicting the findings of an accountant there. Without hesitation, Arthur E. Andersen answered, "There is not enough money in the city of Chicago to induce me to change the report." While he lost the client, the reputation of his company for unyielding integrity was confirmed. 8 In 1939 Andersen established the "Blueback" policy, a value-added service that had partners write a project wrap-up memo (in a blue cover) that detailed any financial, management, or strategy issues that might help their clients. These memos distinguished the company from other accounting firms, which concentrated almost exclusively on the certification of their clients' numbers. 9

As the firm grew, its partners formed a select elite; they all knew and respected each other as professionals. Under the strong leadership of Arthur E. Andersen, who owned the majority of shares in the partnership, an intimate and highly uniform culture developed in which Andersen's personal voice spoke for everyone on matters of policy. He wanted the firm to remain small and directed the officers to seek outstanding talent just out of college—individuals who could be molded in an apprenticeship under a senior certified public accountant (CPA). He preferred young graduates from a modest background who possessed a "Midwestern work ethic" and ideally came from a family farm. In 1940 the apprenticeship system was expanded into a formal training program that all new employees were required to attend. 10 The "Andersen way" was based on (1) honesty and integrity; (2) a one-firm, one-voice partnership model; and (3) training in methodology that was uniformly applied and obeyed. Andersen employees were supposed to appear homogeneous and act predictably, and were "trusted to do as they were taught." And while they should not expect to get rich, they knew that they represented a venerable profession with pride. 11

Spacek's Rule

In 1947 Arthur E. Andersen died without naming a successor. After a leadership crisis, the twenty-five remaining partners eventually elected Leonard Spacek to serve as managing partner (the de facto leader of the firm). Spacek resembled Arthur E. Andersen both in his Midwestern background and his staunch support of the Andersen way. While he could not control the partnership as the majority shareholder, Spacek quickly proved himself a domineering and forceful leader. He had a vision for the accounting profession, and eventually he became well known (and highly unpopular) as a severe critic of accounting standards and practices. 12

To back up his beliefs, Spacek increased Andersen's investment in its training programs, which consumed 15 to 20 percent of the net revenue of the firm. His goal was to create an educational system that would produce "Androids"—professionals of similar background, training, and demeanor—who would maintain the highest and most consistent professional accounting standards. 13 Andersen employees also studied a series of methodologies that taught them technical audit procedures as well as the "proper" persona to display, from the company dress code to required daily appearances in the "correct" business-lunch restaurants. In the accounting profession, Andersen employees became famed as members of a culture that demanded the strictest conformity in appearance and behavior. This culture implied that employees were interchangeable and equally reliable as professionals of the highest caliber. 14

Under Spacek's leadership, Andersen grew rapidly, though cautiously, by entering international markets and offering new services. Rather than seek growth via acquisitions of similar accounting firms, Spacek chose to develop new offices and employees from within through the recruiting and training system. Maintaining a strict hierarchy based on expertise, Andersen sent experienced partners to open and run the new offices, many of which were overseas. As in the United States, the partner in charge of each new office built links with local universities to find high-quality candidates that would fit the Andersen style. 15

Furthermore, the company's consulting business really began to expand in earnest in the early 1950s when it designed and implemented the first business applications for a computer at General Electric. Having beaten the other big auditing companies to the punch in computer technologies, Andersen went on to establish itself as the preeminent provider of consulting services in the burgeoning field. The company began hiring computer consultants, but the new hires introduced a different type of employee to the firm—the consultants were not part of the accounting culture, although in the beginning they received the same training as accountants. Later, the power of the consultants would grow commensurate with consulting revenues. 16

To a degree, the Android culture remained cohesive, held together by the centralized training system and the authority and expertise of the partners. But by the 1970s tensions were brewing. During Spacek's tenure, there was a great increase in the partnership ranks, which had expanded from 25 to 826 members. In addition, Spacek had also presided over a proliferation of international offices. The many partners, spread across several continents, were chafing under Spacek's heavy-handed rule. When Spacek retired in 1973 they voted to ensure that no single partner would ever wield the kind of influence that Spacek and Arthur E. Andersen had; it became the era of "one partner, one vote." Tensions also increased because the larger number of partners meant that they could no longer govern in person ("face to face") as they had done in earlier times. 17 Moreover, the rise of Andersen consultants introduced a new mentality into the company—salesmanship in search of discretionary funds from clients—that differed fundamentally from the legally required services that external auditors provided year by year. 18 As a result, cooperation and cultural cohesion began to weaken, as did the ability of the firm's managing partner to lead.

Growth and Reorganization

After Spacek's departure, the firm continued its rapid growth. To govern it more effectively, the new managing partner, Harvey Kapnick, broke the firm into service divisions of consulting, tax, and audit in the mid-1970s. While adopted to create manageable units, this move effectively split the firm into competing fiefdoms, with consulting experiencing the most rapid growth. According to some observers, at this moment the "common good" ceased to be the basis of company loyalty, and division and geographic location became the ties that bound people together. Consultants fought for, and won, the right to bypass the training regimen of the accountants, which further undermined the uniformity of Andersen's culture. 19

External factors also began to impact the firm. First, while audit revenues were dependable as a legal requirement for public companies, their profitability had hit a plateau. The U.S. government was pursuing efforts to inject more competition into the auditing industry. Prior to a 1973 legal challenge for violation of antitrust laws, industry associations had prohibited competitive bidding between accounting firms; four years later, similar industry bans on advertising were lifted. In addition, a wave of consolidation added to the competition between firms. Increasingly, clients were offered packages of audit services that resembled commodities, accompanied by advertising campaigns. As a result, consulting revenues became an increasingly important source of profit within the firm. 20

Second, in the wake of the merger-and-acquisition trend that began in the 1960s, disappointed investors began to seek legal compensation for failed deals—often from accounting firms. To respond to the explosion of audit-related litigation, Andersen adopted a damage-control policy on the advice of its lawyers. 21 In addition, the firm joined the other big accounting companies to pool resources in an insurance fund to pay shareholder settlements.

Third, Andersen and the other major accounting firms began to consult each other regarding lobbying campaigns in order to oppose regulatory oversight from the SEC and other agencies, as well as to avoid political pressure from the U.S. Congress. 22

In the face of these new conditions and pressures, some inside the firm began to fear that audit standards were slipping. For them, Andersen's responses to the challenges it faced appeared largely defensive and reactive, paying little attention to the strategic direction of the company. The situation was, in their eyes, ripe for conflicts of interest to develop: in their search for big clients, many accountants had begun to act like salespeople for consulting contracts while doing their jobs as external auditors. Others argued that Andersen was still the best and that local partners could be trusted to do their jobs competently and with integrity. 23

In the late 1970s, for example, Andersen won the DeLorean sports car account, which was secured in large part by partner Dick Measelle. John DeLorean, a flamboyant character, promised significant revenues for the firm. When presented with evidence that DeLorean was charging personal luxury expenses to his company—his Mercedes-Benz, some household items, and even a personal assistant—Measelle accepted his client's explanations and offered Andersen's approval of the company's books. Rather than challenge DeLorean's bookkeeping, Measelle appeared eager to accommodate DeLorean. Upon DeLorean's company's bankruptcy, the oversights sanctioned by Measelle and his colleagues led Andersen to pay $62 million to settle lawsuits with disgruntled investors; in addition, the British government barred Andersen from auditing in the country from 1985 to 1997. However, rather than suffering a damaged career, Measelle was promoted for his ability to bring in clients like DeLorean, and he eventually served as CEO. Apparently, most in the company viewed the DeLorean debacle as a one-off incident rather than a pattern that might indicate future problems at the firm. 24

The Rise of the Consultants

As the company entered the economic boom of the 1990s, its focus shifted to profitability, eclipsing Andersen's spirit of public service. Because the new leadership viewed consultants and investment bankers as examples they wished to emulate, tremendous pressure was created within the company to find new sources of revenue. However, many other forces began to impact the firm as well, including internal tensions and pressures from government reformers.

The Consultant/Auditor Balance Shifts

Back in 1979, the Andersen partners had chosen information systems consulting as the way to make up for the slow growth in audit revenues. While auditors continued to control the partnership, the consulting division operated autonomously and began to develop its own subculture. The group recruited veteran engineers, computer scientists, and consultants with little (if any) experience in accounting and sought business differently than Andersen had in the past. Consultants were salespeople; they were required to innovate, sell, and perform cutting-edge computer services, always with an eye to initiate a new consulting cycle for additional services. The major competitors, EDS and IBM, were cutting-edge technologists, which increased the pressure. Consulting hires also expected faster promotions, pay and bonuses that were directly tied to their immediate contributions, as well as a shorter wait to make partner. This “sales” mentality stood in stark contrast to the traditional mission of Andersen accountants: protection of the shareholders and the public interest in proper reporting standards. 25

During the 1980s, consulting began to overtake auditing as a percentage of total revenues at Andersen (see Exhibit 1). However, of 2,134 partners in 1989, only 586 were consultants. In addition, on a per-partner basis, consultants were bringing in $2.3 million, while accountants achieved only $1.4 million. Not surprisingly, the consultants began to agitate for greater power within the organization. This led to a series of lawsuits between partners that further undermined the unity of the Andersen culture. The consultants eventually became an independent business unit called Andersen Consulting in 1989, as opposed to simply a division. The split allowed both the accounting and the consulting units to track all accounts separately, including income and profits. Each unit began to operate on its own floor of the same office building as an entirely separate entity. 26 Although Arthur Andersen was largely restricted from engaging in consulting, the accounting side was still permitted to pursue consulting with clients that had less than $175 million in annual revenue.

While the arrangement appeared to work, it only papered over deeper fissures within the organization. Resentment and professional jealousies continued to fester, with accusations of disloyalty as well as a sense that the "stodgy" accounting side was holding the consultants back. As the split became ever more apparent—the two groups began to act as if they were independent companies—the tension between the two cultures became increasingly bitter and divisive. 27

The Rainmakers

While there was no decisive turning point in the evolution of the company, leadership of the accountants (within Arthur Andersen & Co.) slowly shifted to those who could bring in new business—the "rainmakers." Unlike their predecessors, whose expertise was in technical accounting and auditing skills, these young leaders were distinguished by their ability to attract profitable consulting engagements. 28 In 1992 this transition culminated in a huge purge of low-performance partners. Ten percent of all partners were forced out; often, some of those who departed represented the traditional values of the firm and had functioned as mentors to younger accountants. As a result, oversight of younger partners was sharply curtailed, while the local independence of Andersen offices grew. 29

The Professional Standards Group (PSG), an oversight office within Andersen that was once a plum assignment for the future accounting elite, visibly diminished in importance. During the 1980s, for example, the PSG had ruled that stock options should be categorized as an expense—that is, as a charge against profits, identical to other forms of compensation. However, at the start of the 1990s boom, when stock options were rapidly increasing in popularity and prestige, both the high-tech industry and the U.S. Congress pressured accounting industry leaders to consider a different interpretation. After a brief debate, Andersen's top leaders reversed the PSG ruling, allowing firms to avoid categorizing stock options as an expense. Many of Andersen's old guard saw this as a shocking precedent. While the PSG would continue to make rulings and pronouncements, local offices had gained a new independence to overrule voices that dissented from their judgment calls on-site. 30 During this period the company continued to sell lucrative services to their audit clients in the 1990s, and this strategy enabled top partners to triple their earnings. In 1994 Arthur Andersen created a formal practice entitled Arthur Andersen Business Consulting (AABC).

Some partners voiced concerns that in their effort to use audits as a gateway to far more lucrative consulting arrangements, Andersen auditors were trying to please their clients rather than carrying out their traditional audit functions. For example, in 1996 then-partner Barbara Toffler attended a lavish party to celebrate the twenty-five-year anniversary of Waste Management's IPO as well as its longstanding professional relationship with Andersen. While there was no reason at that time to suspect anything about Waste Management's accounting practices, Toffler later wrote, "[Andersen and Waste Management] were acting like they were on the same team—not as if one was supposed to be the other's gatekeeper." 31 It was during this period that Andersen's accountants began to conduct both internal and external audits on the same clients, in effect operating on both sides of the coin—aiding corporations to prepare their books while at the same time providing accounting oversight functions. 32

Enter the SEC

The issue of independence between the auditing and consulting functions began to concern SEC Commissioner Arthur Levitt. 33 Early in his tenure, under pressure from the U.S. Congress, he had accepted (against the advice of the Financial Accounting Standards Board (FASB)) its contention that "expensing stock options" would be too costly to so-called "New Economy" startups. As he watched executive pay "spiral out of control in the mid-1990s," he regretted his earlier decision and chose to open a new battle on auditor independence. In June 2000, despite the opposition of the largest accounting firms, Levitt proposed tough new rules that would bar accounting firms from consulting for their clients. 34

A bitter political battle followed in which the big accounting firms lobbied Congress to pressure the SEC. Fortunately, a young peacemaker emerged from within the industry: Joseph Berardino, a partner from Andersen known for both his ability to attract clients and his integrity. Berardino negotiated compromises between all parties that structured a final deal, and he became known as "Levitt's secret weapon." 35 While Levitt had to abandon the strict separation that he proposed, the big accounting firms agreed to two principles. First, they had to disclose what they earned from auditing and consulting fees; and second, the audit committees of company boards had to certify that their non-audit services were compatible with their independence as auditors. While Levitt was impressed by Berardino's shuttle diplomacy, he concluded the affair with misgivings about the accounting profession and the quality of its leadership. Accounting firms, in his view, were all facing the same challenges regarding their independence and potential conflicts of interest. 36

The Divorce

In dollar terms, the emphasis on sales and profit at Andersen appeared to be a success. The firm's overall revenues grew from $3 billion in 1988 to $16 billion in 1999; during that time, employee rolls quadrupled. 37 Nonetheless, the auditors were beginning to compete directly with the consultants for the same clients, and, fearing cannibalization from the accountants' unit, the Andersen Consulting partners voted unanimously in 1997 to secede from Arthur Andersen. To come to terms with the corporate divorce as specified in Andersen Worldwide's partnership agreement, George Shaheen, the head of Andersen Consulting, initiated an arbitration process at the International Chamber of Commerce in Paris; he argued that the competition between the two sides of the company violated the company's existing division of labor agreement. At that point, relations between the two business units had degenerated into open hostility. 38

This contentious corporate divorce initiated years of upheaval for Andersen leaders, who were uncertain what the final structure of the company would be. It diverted the attention of top management from other, perhaps more pressing, questions, such as the overall direction the firm should take and whether, as a highly decentralized partnership, the company could be governed effectively. In August 2000 the International Chamber of Commerce came down on the side of the consultants, agreeing with Shaheen's contention that the accounting side had violated the agreed-upon division of labor between the groups. To become a separate corporate entity, Andersen Consulting was required to relinquish the Andersen name and pay $1 billion, far below the $14.6 billion that many Arthur Andersen partners had demanded and expected. 39 In January 2001 Andersen Consulting changed its name to Accenture. This constituted not only a successful re-branding campaign, but the new company assumed no legal liability for the many charges that Arthur Andersen was facing. 40

Leaders in the accounting unit were extremely bitter about the unexpectedly low settlement from the divorce, and they felt renewed pressure to find additional sources of revenue in a stagnant market for traditional accounting services. 41 The push for profit, in the view of some partners, overtook all other concerns. Internal competition to claim the principal responsibility for certain clients, and thereby earn points toward the year-end bonus, became particularly fierce. According to Toffler, the firm felt "rudderless." 42

Waste Management

Because of its long and intimate professional relationship with the firm, many of Waste Management's internal accountants had been hired from Arthur Andersen, including virtually every chief financial officer and every chief accounting officer. Robert Allgyer served as the lead Andersen partner for the Waste Management account. According to Dick Measelle, the Andersen partner who had been promoted after the DeLorean incident, "Allgyer had a reputation as a businessman who was able to sell." 43 Another Andersen partner involved with Waste Management was Robert Kutsenda, who, as audit practice director from the Chicago office, was charged with final oversight on technical issues. Like Measelle, Kutsenda had been promoted for his sales ability in the wake of another major embarrassment for Andersen, the Supercuts account, in which he had signed off on some aggressive accounting. 44

The SEC investigation of Andersen accounting proceeded, relying heavily on subpoenaed emails and memos written by Andersen employees. During the investigation, it appeared that Andersen auditors had uncovered a number of questionable practices at Waste Management as early as 1988. For example, Waste Management was attempting to increase its value by overestimating the salvage value of its older garbage trucks, in effect claiming that they were worth $30,000 when the actual figure was closer to $12,000. 45 There were a number of similar instances of aggressive accounting, such as failing to properly depreciate the trucks, which many inside Andersen defended as judgment calls on local issues that accounting norms had not yet addressed clearly. While Andersen auditors had brought many of these issues to the attention of Waste Management executives (as well as to Andersen CEO Measelle), they did not press them to correct the company books, as documents subpoenaed by the SEC attested. Indeed, the Andersen auditors could have resigned in protest, but instead they chose to manage the risk of a valuable client. During the investigation, Andersen lawyers argued to the SEC that the auditors and the responsible partners had followed "accepted standards." In Toffler's view, however, "the auditors simply caved when the company refused to implement the changes they wanted.… So [the lead partners on the account] simply certified the audit and decided to hope that the company would see things their way the next year." 46

At the conclusion of the investigation in February 2001, the SEC determined that Arthur Andersen's audit reports on Waste Management were “materially false and misleading.” Allgyer, who had already resigned, was suspended from practicing for five years, allegedly because he “recklessly caused the issuance” of the misleading reports. For his part, Kutsenda was suspended for one year, for conduct “in violation of applicable professional standards.” Andersen agreed to pay a $7 million fine—the largest ever levied against an accounting firm—with no admission or denial of guilt regarding the violation of professional standards. As part of the deal, however, Andersen also agreed to an injunction that it would adhere to generally accepted accounting practices/standards (GAAP/GAAS) in the future—in effect, a legal commitment to never again violate securities laws. It was akin to being placed on probation. 47

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16. Toffler and Reingold, 71–72.

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32. Ibid., 143.

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Arthur Andersen (B): From Waste Management to Enron

In addition to paying the fine of $7 million to the U.S. Securities and Exchange Commission (SEC) in 2001, Arthur Andersen faced a series of lawsuits filed by Waste Management stockholders; eventually both firms settled with the plaintiffs for a total of $228 million. Waste Management was acquired by a competitor and lent its name to the new entity. The SEC injunction, which prohibited Andersen from "future misdeeds," put the firm on notice that it was under strict regulatory scrutiny. There was little room, it seemed, for further missteps.

Promotions

Of the Andersen partners who had been directly involved with Waste Management, only Robert Allgyer left the firm. The others continued as partners, and some received big promotions. The highest-ranking partner involved, Robert Kutsenda, was promoted to managing partner of global risk management, despite receiving a one-year suspension as a result of the SEC investigation. Because Andersen had suffered penalties in shareholder lawsuits based on its internal documents, one of Kutsenda's most important new tasks was to formulate a policy to limit Andersen's exposure to additional suits. He did so in a "retention and organization" policy, which was formulated in February 2000. "Information gathered or considered in connection with performing client engagements," the policy stated, "should be evaluated by the engagement partner… and only essential information to support our conclusions should be retained." 1 While the policy did not spell out how this might translate in practical implementation, in May of that year it was sent to every Andersen employee by e-mail. 2

New Leadership

After Andersen's consulting unit won independence through arbitration in August 2000, a strong leader was needed, and in January 2001 the partners chose Joseph Berardino, who had distinguished himself during the accounting-consulting separation negotiations that occurred with the SEC and the other big accounting firms. At the time of his appointment, which coincided with the popping of the stock market bubble, many within the firm were worried that the contraction of the information-economy sector would impact revenues. 3

Berardino had been with Andersen for twenty-nine years when he was chosen as CEO. Hired fresh out of college and trained in-house in accordance with company tradition, Berardino had made partner in ten years and enjoyed the reputation of being a stickler for details. He had overseen the audits of a number of major clients, including Merck, Colgate-Palmolive, and the National Football League. While some of his clients were known for their complex financial accounting methods, Berardino had not been involved with any of the company's clients that were under investigation. He would, many hoped, bring the company back to its roots as a dependable auditor. 4

Tip of the Iceberg?

During the Waste Management investigation, a rapid succession of similar accounting crises came to light. While many Andersen representatives argued that these kinds of problems were inevitable and that they by no means indicated any systemic problem at work, the new cases bore striking similarities to both the DeLorean and Waste Management incidents. They included:

- The Baptist Foundation of Arizona (BFA). BFA managed tax-deferred individual retirement accounts for 11,000 elderly investors. It was alleged that BFA was a Ponzi scheme, in which investors were paid with the money of new investors in a continual cycle. When BFA filed for bankruptcy in November 1999, the foundation was $360 million in the red; investors lost $570 million. Claiming their auditors knew nothing of these irregularities, Andersen settled with investors out of court for $217 million and paid a fine. 5
- Sunbeam. To create the appearance of a successful restructuring at this small-appliance company, Sunbeam CEO “Chainsaw Al” Dunlap allegedly manipulated sales records by categorizing contingent sales as “definite”—shifting sales from later quarters into the present one to beef up results. While Andersen claimed that its auditor acted “with the appropriate degree of skepticism,” the SEC disagreed, charging that he should not have signed off on Sunbeam's financials. Again without admitting guilt, Andersen settled with Sunbeam shareholders for $110 million in April 2001. 6

Andersen was not alone in its problems—other big accounting firms were experiencing similar crises. For example, Ernst & Young agreed to pay $335 million for failing to uncover accounting fraud in the Cendent case. More generally, with 51 percent of Big Five accounting firm revenue coming from management consulting by 2000, SEC commissioner Arthur Levitt cited conflicts of interest between the auditing and consulting functions of accounting firms as the root of a rising tide of accounting failures that had cost shareholders $88 billion in seven years. 7

Enron

Enron was one of the great success stories of the “New Economy” boom. The company was an energy trader that hired “talent,” then gave its young employees great latitude to accomplish their objectives; its stock had risen steadily, sometimes nearly doubling in value in one year. Andersen had been chief accountant for Enron since the company's founding in 1985. In the eyes of Andersen's lead partners, Enron was not only a huge source of revenue in both auditing and consulting but also an attractive client to be associated with. Recalled one audit manager: “It was like these very bright geeks at Andersen suddenly got invited to this really cool, macho frat party.” 8

By the early 1990s, as Enron began to experience extremely rapid growth, the relationship between the two firms became closer. First, Andersen added internal accounting responsibilities—for example, advising Enron on the efficiency of its operations and helping to prepare its financial documents—to its external auditing function, in effect providing services that other auditors from the same firm would later check. Second, close personal relationships were forged between the two companies' leaders. 9 Since 1997, Enron's lead on-site Andersen partner was David Duncan. A Texas native, Duncan had been a partner for two years and was thirty-seven when he was put in charge of the account. Duncan was viewed as one of the firm's stars—excellent at sales, popular with clients, very smart—and was featured as an example for aspiring partners to follow. He was also a personal friend of Rick Causey, an Andersen alumnus who would become Enron's chief accounting officer; they took vacations together and co-chaired local fundraising events. 10

The mode of operation that Duncan inherited was a complex arrangement of negotiation and pressure from Enron. Because Enron was engaging in a wide range of unusual financial transactions, there was a constant debate regarding what should be allowed. Typically, if Andersen accountants objected to something, Enron managers would call the firm's Chicago headquarters to make their case, often over hours of conference calls in which the partners and their assistants there sought to find ways to approve Enron's desired approach. Said one witness: “You would try to find ways to do it. We all knew they were the largest single client [in the Houston office].” 11

For example, Enron argued that it “could obtain a truer, more current valuation” of its assets with “mark-to-market” accounting, a practice that enabled the company to count as current earnings the profits it expected to gain in the future from energy-related contracts, sometimes even twenty years in advance. 12 When Andersen accountants in Houston appeared reluctant to endorse this change in its accounting practices, Enron representatives bypassed them, traveling directly to Andersen's Chicago headquarters to make their case. Once Enron gained Andersen's agreement to mark-to-market, it enlisted the firm to make the case for it to the SEC, which had previously turned down Enron's request. Eventually, Andersen won SEC approval on behalf of Enron. 13 While it was a judgment call as to whether this practice was legitimate—mark-to-market was originally applied in trading houses to assets like stocks, and not to oil and gas commodities 14 —it became one of the principal tools in Enron's efforts to enhance corporate results. In 1999 projected earnings from mark-to-market accounting were responsible for a third of Enron's pretax profits, and in 2000 that number had increased to half. 15

Many Andersen employees were also uneasy about Enron's increasingly numerous and complex off-balance-sheet partnerships, known collectively as Project Raptor. Carl Bass, a member of the Professional Standards Group (PSG) who worked on the Enron engagement, advised Duncan against signing off on Project Raptor, concluding that it was designed to allow the company to hedge itself. 16 The PSG was a panel of technical experts that for years had served as the ethical backbone of the company, generating policies for myriad complex accounting issues; however, the panel's influence had gradually waned as local offices gained more independence. Bass did not understand how Andersen could sign off on the double role that Enron chief financial officer Andrew Fastow was playing: Fastow both oversaw the partnerships and ran several of them, which Bass viewed as a conflict of interest.

Despite numerous warnings and even direct orders from Bass to disapprove certain accounting calls, Duncan and the practice directors in the Houston office were able to overrule the PSG. 17 In one instance, when Bass reminded Duncan of his earlier order that Enron should be “required” to report losses in the partnership Azurix, Duncan replied that he had not passed on the original advice and concluded: “I can't go back and do it now.” 18 Much later, Bass learned that Duncan had sometimes misrepresented his advice—writing that he approved certain transactions when in fact he had not—in internal file memos, in particular regarding the Raptor partnerships. 19

Eventually, Bass's persistent and outspoken criticism of some of the energy company's accounting practices led Enron chief accounting officer Richard Causey to bluntly request his removal: “Enron,” Causey stated, “does not want Carl Bass consulting on anything involving the company anymore.” [20] Bass had come to be viewed as an impediment, and Andersen eventually yielded to Causey's demand. [21]

The Shredding

By September 2001, the losses in several of Enron's off-balance-sheet partnerships became impossible to hide. Not surprisingly, the relationship between the two firms soured. According to Benjamin Neuhausen, a member of the PSG: “A billion-dollar debit needed to find a home. It was classified as an asset incorrectly.” [22] Enron representatives argued it was best to take the charge as a one-off financial hit. For their part, Andersen auditors believed that Enron had provided “misleading information” regarding the partnership losses. It would only be a matter of time, they reasoned, until the SEC would come to ask questions. [23] At this time, Nancy Temple, a young Andersen lawyer who had been at the firm less than a year, was asked to join the firm's discussions on Enron. When asked repeatedly what Andersen's document retention policy was and without clear direction from the firm's leadership, she drafted an e-mail urging “compliance” with the policy; her memo explained that they should keep final versions of memos, but not the drafts and other communications that led up to them. [24]

On October 23, after a disastrous conference call with stock analysts led by Enron CEO Ken Lay, David Duncan told his team that they should “comply” with the document retention policy, which he recalled from Temple's recent memo. [25] Though apparently no one asked what he meant, Duncan's team began an all-out effort to clean out their files. Over the next several weeks, they destroyed more than one ton of documents and deleted approximately 30,000 e-mail messages from their computer files. [26] On November 9, when Andersen received a subpoena from the federal government, Temple ordered an immediate halt to the shredding via e-mail. [27]

In the meantime, the price of Enron's stock continued its decline, falling from a high of $90 per share in August 2000 to $0.61 on December 2, 2001, the day Enron declared bankruptcy. At that time, it was the largest corporate bankruptcy in American history. [28] Unlike Andersen's previous accounting problems at Waste Management or Sunbeam, the Enron debacle was front page news. Facing a weakened stock market, shareholders were frightened; their concern sparked the interest of a number of congressmen, who announced investigations. Suddenly, the issue promised to become political. In preparation for a January 2002 visit from congressional staff investigators, the document shredding policy was discovered, which shocked partners in the Chicago office. [29]

At that time, Assistant Attorney General Mike Chertoff, chief of the Justice Department's criminal division, was contemplating an indictment against Andersen for obstruction of justice. No large accounting firm had ever been indicted before, and most understood that it would ruin the Andersen reputation and kill the partnership. For his part, Berardino doubted that an indictment was forthcoming, but he began to consult Andersen lawyers on a course of action. [30]

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Arthur Andersen (C): The Collapse of Arthur Andersen

In January 2002 Andersen CEO Joseph Berardino remained optimistic that his company would avoid indictment by the Department of Justice (DoJ). When Berardino discovered that documents had been shredded and e-mail messages deleted on orders from David Duncan, the lead Andersen partner on the Enron account, he immediately informed the Securities and Exchange Commission (SEC) and the DoJ. Some argued that Andersen should put together a communication strategy that would explain the extent of information that was destroyed as well as provide context for the firm's behavior. However, Andersen attorneys convinced Berardino that this was not necessary. Not surprisingly, Andersen's statement—that “a significant but undetermined number” of documents were destroyed—made headlines, and no less than seventeen congressional committees announced investigations into the affair. 1

Andersen's credibility was severely damaged, and some of the company's clients, such as Sara Lee Corporation, began to contemplate finding a new accounting firm. As client defections grew, the very survival of the firm appeared to be at stake. An indictment, Berardino knew, would kill the firm regardless of the outcome of the trial. A few days later, Berardino fired Duncan. He then convinced Paul Volcker, the former chairman of the Federal Reserve Board whose monetarist policies were credited with stopping the stagflation of the 1970s, to lead an independent oversight review board. Volcker demanded broad powers and access, which Berardino promised. Volcker also proposed a plan to strip away consulting functions once and for all from the accounting side and to make the company a model for reforming the entire accounting profession. 2

In the meantime, Andersen lawyers argued to the DoJ that an indictment was unnecessary. The firm, they claimed, was cooperating fully. They suggested that the responsible auditors be indicted as individuals and that the firm pay a fine and then negotiate a settlement with investors; in this scenario, not only would the entire firm avoid indictment, but it would avoid any admission of guilt. It was the formula that Andersen lawyers had developed to resolve the Waste Management, Baptist Foundation of Arizona, and Sunbeam problems. But this time the approach failed. Some DoJ prosecutors and law enforcement officials voiced outrage at the firm's “arrogance.” They were inclined to indict the entire firm and said so. 3

In an attempt to save the firm, Berardino shifted his strategy and opened merger talks with other accounting firms. He then turned over most of his responsibilities to a group of senior Andersen partners. Volcker's proposed review board never got off the ground, despite its initial promise. Though many Andersen employees rallied to Berardino, they soon began to leave the firm for its erstwhile competitors; with his credibility evaporating, Berardino resigned in late March 2002. 4

Andersen then made a settlement offer to the DoJ, which Volcker presented to the federal prosecutors under Assistant Attorney General Michael Chertoff. The firm offered to:

- Admit mistakes
- Cooperate with the Enron investigation
- Institute Volcker's suggested reforms

- Pay fines to the SEC and serve a long probationary period
- Revamp its document retention policy

However, in spite of an apparent interest on both sides to settle the matter outside of court, the deal apparently fell apart due to Chertoff's insistence that Andersen admit criminal responsibility. With Duncan's confession of obstruction of justice, the DoJ issued an indictment to that effect, which became public on March 14, 2002. This effectively destroyed the remaining credibility of the firm. Andersen's major corporate clients abandoned it in droves, and a tidal wave of lawsuits besieged the company.

To many observers, the trial that followed was a mere formality because Andersen had essentially ceased to function as a working firm; nevertheless, Andersen attempted to defend its good name. A vocal portion of the firm's employees were outraged by the legal proceedings: not only did they believe they were "the best" in the profession, with the highest ethical standards, but they denounced the DoJ case as "politically expedient," that is, designed to show the government was "doing something" to restore confidence in the economy. In their eyes, the entire firm was being blamed unfairly for the actions of a few wayward employees and the dishonest and misleading actions of its clients. Many at Andersen assumed that the obstruction of justice case was weak and not based on credible evidence. 5

However, as the trial began on May 6, 2002, there were a number of surprises. First, the judge allowed the prosecution to present evidence from previous out-of-court settlements from Waste Management and other incidents. This allowed the prosecution to establish a motive for the shredding, convincing many in the jury that Andersen had sought to destroy evidence of wrongdoing. Second, Duncan appeared as the star witness for the prosecution; he testified that, upon reflection and contrary to his earlier pronouncements, he had indeed obstructed justice. 6 Third, the prosecution concentrated not on the document shredding but on a memo from the young Andersen attorney Nancy Temple, who had urged Duncan to delete the word "misleading" from one of his descriptions of Enron's accounting methods; even worse, the prosecutors argued, Temple had requested that her name be deleted from the e-mail. The Temple memo, the prosecution reasoned, violated a 1988 federal law that made it a crime when a person "corruptly persuades" someone to "alter, destroy, mutilate, or conceal" a document with the intent of making it unavailable "for use in an official proceeding." This widened the applicability of the law in a manner that virtually ensured an appeal would follow any conviction. 7

After initially deadlocking, the jury interpreted the Temple memo as an attempt by Andersen to obstruct justice and rejected the claim by Andersen lawyers that it was merely a "routine correction." In mid-June, the jurors delivered a guilty verdict. Andersen then announced it would cease all auditing of public companies in August 2002. 8 Although many argued that prosecutors had "overzealously" pursued Andersen, the announcement of $3.8 billion in accounting errors within two weeks of the verdict by WorldCom Inc.—another Andersen client—momentarily silenced critics. The SEC immediately began discussing investigations into Andersen's auditing. When WorldCom declared bankruptcy less than a month later, it surpassed Enron as the largest in American history and prompted the dramatic overhaul of securities law known as the Sarbanes-Oxley Act. 9

Andersen, which had shrunk to 200 employees from a high of 26,000 in the United States and 85,000 worldwide, initiated an appeal of the conviction. Although the firm had effectively ceased to exist and overturning the conviction would never enable its resurrection, much remained at stake. The firm faced a series of legal disputes with shareholder plaintiffs who were seeking financial redress for the auditing errors of its bankrupt former clients, some in lawsuits directly targeting the personal assets of Andersen partners. The criminal conviction had invalidated Andersen's insurance against legal liabilities to the shareholders of failed Andersen clients. 10 Overturning the conviction could protect the personal assets of Andersen partners from at least some of the lawsuits as well as unfreeze certain assets for distribution to former Andersen partners; it would also re-open the possibility that shareholders from failed Andersen clients might receive some financial compensation from insurers. 11 Lawyers argued on behalf of Andersen that the DoJ had used a "vaguely worded statute," in effect criminalizing what should be regarded as normal behavior in most corporations: the destruction of drafts, notes, and other communications that were not required to document a final audit opinion. The Andersen appeal focused on the phrase "corruptly persuade," arguing that it referred to "at least conscious wrongdoing," which the government had not proven in the trial. After failing in the federal appeals courts, the Supreme Court announced on January 7, 2005, that it would review the criminal conviction of Arthur Andersen.

On April 26, 2005, the U.S. Supreme Court heard the appeal from Andersen's lawyers; the lawyers argued that the government's use of a 1982 law, the Victim and Witness Protection Act, was improper regarding the conviction for obstruction of justice because no "official proceeding" of the government had been underway at the time the documents were destroyed, and the Sarbanes-Oxley Act of 2002, which tightened these requirements, had not yet existed. In addition, they argued, the instructions from Houston judge Melinda Harmon regarding the definition of "corruptly persuade" failed to include the standard of an "improper means," that is, via bribery or with the knowledge that they were violating the law. The Justices of the Supreme Court appeared to favor the defense. Their comments and questions included:

- That the government's approach was "a sweeping position that will cause problems for every business in this country." (Anthony M. Kennedy)
- "If I were a juror, I might think that what is missing here is dishonesty of purpose." (Stephen G. Breyer)
- "If this thing is so confusing, how is a businessperson supposed to know what to do? How's a lawyer to know?" (Sandra Day O'Connor)
- "That's weird." (Antonin Scalia) 12

At the end of May 2005, the Supreme Court unanimously struck down the criminal conviction of Arthur Andersen. According to the majority opinion as written by Chief Justice William Rehnquist, Judge Harmon "failed to convey the requisite consciousness of wrongdoing. Indeed, it is striking how little culpability the instructions required." 13 In other words, she had not included the criteria of acting dishonestly or with consciousness of wrongdoing. Rehnquist continued: "We have traditionally exercised restraint in assessing the reach of a federal criminal statute… [people deserve] a fair warning" that their conduct is not legal. 14

Many hailed this as a vindication for the firm, which would serve to restrict the reach of overzealous prosecutors. However, some observers argued that the rejection was based on narrow technical grounds that failed to offer any perspective on the evidence of obstruction of justice as presented by the federal government. The case was referred back to the Houston courts to await a decision regarding whether to re-try the firm. 15

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