Arthur Andersen (B)

On December 4th, 2001, three days after its story announcing the SEC subpoena of Arthur Andersen documents, the Wall Street Journal ran an editorial written by then-CEO of Andersen, Joseph Berardino. In his editorial, Berardino addressed what he considered the broader range of issues surrounding Enron’s bankruptcy. Berardino was not the first to point out industry wide weaknesses revealed by Enron’s misreported earnings; industry observers had warned since the 1990s that Big Five accounting firms had entered uncertain territory with their auditing practices and debate over regulatory reform already existed in Congress. Berardino singled out the issues of accounting rules that do not apply to new financial structures, a confusing model for corporate financial reporting, and a weak regulatory environment, as contributing factors in Enron’s downfall. These larger problems, he asserted, did not apply only to Andersen as a potentially liable auditor for Enron, but to the auditing and accounting industry as a whole-- his company was not unique.

Although there was general agreement in the U.S. at that time that accounting rules needed improvement to reflect modern business practices, Berardino had low credibility as a newly emerged champion of this reform. Berardino had led the accounting industry’s lobby in resisting earlier attempts by the SEC to impose restrictions on auditors. His company’s reputation was compromised before Enron by bankruptcies and fraudulent accounting at former clients Sunbeam and Waste Management. Enron’s collapse appeared to confirm the failure of internal reforms following these earlier mistakes. Berardino’s public pledge that his company would help all accounting firms learn from the lessons of Enron was difficult to believe given Andersen’s own difficulty in learning from its bookkeeping mistakes in the past.

The Nov. 29th announcement of an SEC subpoena of Andersen files was the start of a cascade of events that further undercut Andersen’s reputation. The timeline included here as Exhibit 1 highlights major crisis moments for Arthur Andersen that began in the fall of 2001 and continued through the summer of 2002. Andersen did respond publicly to many of these events. Berardino issued his editorial at the beginning of December. Throughout January, Andersen ran advertisements in major newspapers to remind the public that the Houston office was only a small portion of an accounting firm with over 85,000 honest employees. Andersen brought attention to internal attempts at restructuring under the lead of Paul Volcker beginning in February. In response to each major legal action by the government, Andersen lawyers issued rebuttal statements that were published in major national newspapers.

Efforts to generate more positive interest in Andersen came amidst frequent unflattering media reports that covered everything from acquisition of new evidence in the case against the auditor to employee layoffs and a shrinking client base. Andersen’s efforts also faced immense public ill will against anyone implicated in Enron. Berardino could not exonerate his company from its now-closely observed mistakes in its struggle to survive the Enron debacle.

A History of Problems

Arthur Andersen had a history of problems with the SEC. The Waste Management and Sunbeam accounting scandals at the end of the 1990s left Andersen executives concerned about the potential legal ramifications of some of Andersen’s accounting practices. When Enron’s public problems began in 2001, the record of Waste Management and Sunbeam returned to haunt Andersen as evidence that the company had a history of major accounting mistakes. With such a history, Andersen did not appear to be an unwitting victim of a single corporate bankruptcy that highlighted industry-wide accounting problems, but rather a firm that had known for years that its accounting practices violated SEC regulations.

Berardino became CEO of Andersen in early 2001 with promises to enact reforms that would help the company move past earlier improprieties while guarding against future investigations. Public problems with Enron began less than a year into his term. On February 4th, 2002, in a display of a commitment to fundamental restructuring at the firm, Arthur Andersen engaged respected Federal Reserve chairman Paul Volcker to oversee an independent review committee to determine how to accomplish further reforms.

Sunbeam, Waste Management, and Enron were not the only Andersen clients to hurt the company’s reputation with high profile bankruptcies during the 2001-2002 period. On March 4th, 2002, Andersen lawyers agreed to pay $217 million to settle pending litigation with the Baptist Foundation of Arizona (BFA). The BFA made history as the largest non-profit bankruptcy when it filed for Chapter 11 in 1999, at a cost of $600 million to investors. A few weeks after the original settlement, the Baptists returned to headlines as the agreement fell apart and Andersen prepared to go to trial on felony fraud charges. In July of 2002, a bankruptcy court re-approved the $217 million settlement in light of the unlikelihood that any litigation against the troubled company would yield higher returns for the BFA. While the BFA did not have the same media coverage as Enron, it served to remind the American public that Enron was not an isolated incident for Arthur Andersen.

The ongoing revelations of past and present accounting errors at Arthur Andersen created the impression that any corporation could have hidden errors similar to Sunbeam, Waste Management, Enron, and the BFA. At the same time as the public read about the record of past accounting mistakes, more and more of Andersen’s existing clients announced their plans to find new accountants.

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Obstruction of Justice – The Shredding Incident

On October 12, 2001, Nancy Temple, a lawyer at Andersen’s Chicago Headquarters, sent an e-mail reminding employees of the company’s document retention policies. David Duncan, head of the Houston office, received the message the same day. On that day his office began to shred high volumes of Enron related documents. On November 9th, the day after issuing its subpoena to Andersen, the SEC ordered that all shredding stop, but many important documents had already been destroyed.

In December of 2001, Joseph Berardino testified to members of Congress that Andersen headquarters had known nothing of Houston’s document shredding at the time of the incident, and that the action had begun under the initiative of David Duncan. This testimony later proved to be false. On January 10th, Andersen headquarters publicly acknowledged that shredding of documents relevant to SEC investigations had occurred at Houston. Five days later Andersen fired Duncan. Duncan claimed that Andersen executives had unfairly tried to focus full blame onto him for document shredding that was a company wide policy. Duncan’s allegations directly contested Berardino’s earlier testimony. Several other employees confirmed that Berardino had given a false account of the document shredding.

On the same day that the inaccuracies in Berardino’s earlier statement became public, Sherron Watkins stepped forward to speak out against Enron’s CEO, Kenneth Lay. Watkins had warned Lay about fraudulent financial transactions almost a year before these transactions came to the attention of the SEC. Lay had not admitted to this prior knowledge. Watkins’ evidence contradicting Enron executives’ testimony combined with Duncan’s contradiction of Andersen’s refueled the public perception of dishonesty in top officials associated with the Enron scandal.

From January until May, 2002, Congress conducted hearings into the Andersen shredding incident. During these hearings, top officials at Andersen invoked their Fifth Amendment rights in questions regarding prior knowledge of Enron document destruction. This refusal to testify did little to restore public confidence in Andersen’s management teams.

Indictment and Conviction

On March 15th, 2002, the Department of Justice indicted Arthur Andersen on charges of obstruction of justice for shredding paperwork related to ongoing SEC investigations. The allegation included not only Houston offices, but also headquarters in Chicago, and offices in London and Portland, OR. No financial firm has ever survived criminal conviction in the U.S. Commenting months later on the effects of the March indictment, Paul Volcker would

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claim that it was as if “a guillotine dropped.” Criminal charges entirely changed the prospects of his bid to salvage Andersen.

Although Volcker remained with Andersen following the indictment, up until the start of the company’s criminal trial, Berardino did not. On March 26th, less than two weeks after the felony charges, Joseph Berardino resigned as CEO of Arthur Andersen. Berardino left the company without an immediate successor in line to take his place. At the same time, the indictment put on hold many of Volcker’s plans for reform. Andersen scrambled to find new leadership. Volcker described the remaining partners as “confused, dispirited. . . it’s very difficult for them to come to a decision about anything.”

On May 6th, 2002, the criminal trial of Arthur Andersen began in Houston. The same day, Paul Volcker announced that his involvement in reforming the firm had ended. The trial lasted for one month, and on June 15, after ten days of deliberation, a jury found Arthur Andersen guilty on a single felony account of obstruction of justice. Andersen immediately announced its intention to fight the ruling, but by that time Andersen officials had already acknowledged that the finding of criminal misconduct and publicity surrounding the case had left the Andersen auditors without a future in U.S. practice. As Lynne Turner, the former SEC chief accountant, summarized: “It’s time to name the person who’s going to turn the lights out [at Andersen] as they go out the door”.

Conclusion

Joseph Berardino began to defend his company by directing attention away from Arthur Andersen specifically and on to more fundamental problems among the Big Five accounting firms. Old rules for recording transactions no longer applied; auditors faced unprecedented volumes of information to process, leading to unintentional errors; the regulatory structure failed to adequately check auditors’ work and in the new environment of close auditor/client relations, Andersen headquarters could not micromanage each partner’s branch.

Berardino’s defense both succeeded and failed. On one hand, the American public and Congress both agreed on a need for major reform of the accounting industry and the regulatory oversight system. By the summer of 2002, Congress had passed bills for corporate reform that would change the rules governing consulting services performed by auditors, increase executive culpability for financial misconduct, and redefine the ways in which businesses recorded their assets and liabilities.

Although Americans viewed Enron as an example of a need to change accounting practices, as Berardino had argued, Berardino’s efforts to share culpability with the entire industry did not save his company. In the months from the November 29th, 2001, announcement of the SEC subpoena, to the June 15th, 2002, jury conviction on a felony charge of obstruction of justice, to the August 31st, 2002, relinquishment of its license to practice accounting to the SEC, the accounting firm made weekly front-page news for misconduct. The American

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public remained fixated on the implosion of both Enron and Andersen and the corporate wrongdoing associated with the collapse.

Many people attempted to save Arthur Andersen. The accounting firm entered 2002 as an arm of a global network with a presence in cities across America and 86,000 employees. By the spring, it was searching for merger partners and shedding its workforce in lay offs or through transfers to other companies willing to accept both former Andersen clients and former Andersen employees. On May 31st, 2005, the United States Supreme Court unanimously overturned the Andersen document shredding conviction on the grounds that the “jury instructions at issue simply failed to convey the requisite consciousness of wrongdoing.” In spite of this, however, most industry watchers speculate that the company will never recover from the debacle. 8 It is not clear how Berardino could have best handled the Enron crisis. What is clear, however, is that, as one Wall Street Journal headline phrased it: “Andersen’s Quest for Respectability Yields a Superb Case of Image Goofs”9.

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