Too Little, Too Late: How the Government could have prevented the fall of Arthur Andersen

Justin Miller
St. John Fisher College, jmiller_no@sjfc.edu
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Abstract
In lieu of an abstract, below is the first paragraph of the paper.

Arthur Andersen's accounting fraud, later costing investors and corporations billions in losses, could have been stopped had adequate governmental regulations been in place to uphold the quality auditing of corporations. Auditing is the outside accountant's main responsibility: double checking financial statements to verify a company's status. Any failure to uphold quality accounting warrants a Securities and Exchange Commission (SEC) investigation, and legislation should be enacted to stop repeated examples of accounting malevolence.
Too Little, Too Late: How the Government could have prevented the fall of Arthur Andersen
By Justin Miller

Arthur Andersen’s accounting fraud, later costing investors and corporations billions in losses, could have been stopped had adequate governmental regulations been in place to uphold the quality auditing of corporations. Auditing is the outside accountant’s main responsibility: double checking financial statements to verify a company’s status. Any failure to uphold quality accounting warrants a Securities and Exchange Commission (SEC) investigation, and legislation should be enacted to stop repeated examples of accounting malevolence.

Many are familiar with Arthur Andersen’s fraudulent partnership with Enron and WorldCom as they were major news stories that received tremendous media coverage. However, the list of companies that Andersen improperly audited is lengthy and dates back to the early Nineties (Squires 113). The public is largely unaware of this early deception because, for example, when Arthur Andersen allowed the books to misrepresent the financial picture of the Baptist Foundation of Arizona, (BFA). The BFA eventually settled their lawsuit without being fully punished (Bartlett v. Andersen ¶ 9).

Andersen’s fraudulent partnerships piled up into crescendo of corporate deceit. Legislation like the Sarbanes-Oxley Act, enacted in response to Enron and WorldCom, should have been passed after the BFA scandal. Self-regulation in the accounting industry failed miserably at stopping Andersen’s deceit. Effective legislation would have curtailed some of the worst examples of corporate fraud this country has ever seen.

An Overview of Andersen

Arthur Andersen was formed in 1913, and “for 89 years it was the mainstay of the accounting profession holding a reputation for honesty and trustworthiness” (Squires 10). In the Eighties it was so dominant that the eight major accounting firms were known as Arthur Andersen and the Seven Dwarfs (Squires 5). Just before the collapse, Andersen had offices in 350 cities worldwide and was previously known as the “Marine Corps of Accounting,” for their quality audits and good reputation (Arthur ¶ 1, Fowler ¶ 20). It employed 85,000 and worked for some 100,000 clients (Arthur ¶ 1, Ex-Andersen ¶ 1). Somewhere down the line Andersen strayed from its reputable beginnings, turning unethical and greedy.

The immediate cause of the shift in ethics came after a period of sixty years. The leadership of Harvey Kapnick grossly expanded Andersen’s size through partnerships. This practice was continued through the early Nineties. Though strong leadership had made the firm a global accounting giant, it grew so fast it lost sight of its humble beginnings out of greed (Squires 73, 77, 89).

Weak Regulation Lays Foundation for Deceit

Investment groups and stock brokers watch earnings statements of corporations and will only buy if favorable economic gains are on the horizon. Arthur Andersen misstated financial statements and neglected its auditing responsibilities to augment positive earnings reports for the corporations it represented. Auditing successful companies on the rise meant greater financial success for Andersen itself. Thus, this cycle of greed led to more profit and more greed. Andersen lost sight of its responsibility to the investing public and was willing to deceive investors for its own financial profit (Letters ¶ 3). The company began to hire employees of similar personality types, often referred to as Andersen Androids. They specifically hired young, quiet, non-combatant workers who would pose the smallest chance of blowing the whistle on the firm’s scams (Squires 125).

America needed the SEC to step up its watch of accounting practices and corporate fraud, but the government standard in the Nineties was ineffectual. It merely called for various small organizations like the Public Oversight Board. Such organizations were known as Self-Regulating Groups because the accounting industry was and had been a self-regulating industry for decades. These groups took on much of the power that the SEC should have claimed. The SEC’s limited powers were set up so that the government could limit the amount of bureaucracy given to the Securities and Exchange Commission upon its establishment. This move proved to be a multi-billion dollar mistake.

A number of specific examples of corporate accounting fraud led to the demise of Arthur Andersen. Throughout five examples the government did not do enough to prevent future auditing fraud. Rather, the government followed a policy of appeasement philosophy and merely fined Arthur Andersen and was foolish enough to believe the firm’s, “promise not to repeat the behavior” (Fowler ¶ 18).

Sunbeam

Going bankrupt in 1998, the Sunbeam Corporation and its auditor Arthur Andersen were the epitome of mismanagement. This first example of
accounting fraud and restated earnings was so bad that the SEC had to step in and curtail the partnership of CEO “Chainsaw” Al Dunlap and Andersen (Sunbeam ¶ 1, Squires 120). Together they misappropriated funds and mistated accounting books to make it seem like the appliance manufacturer was rebounding after a few bad years (Sunbeam ¶ 6). Going beyond its negligent role in the BFA scandal, Andersen now readily took part in the accounting fraud for the sake of its own increased revenues. It shredded documents that would have incriminated both Andersen and Sunbeam executives. The SEC finally stepped in after bankruptcy was filed. This was only after Andersen helped the company fraudulently misstate $189 million (Settlement ¶ 5).

In Bankruptcy Court, Andersen paid only $110 million to the shareholders of the company it was financially corrupting (Settlement ¶ 7). The SEC investigated Andersen for the first time in what would later prove to be their final years, yet failed to bring them to adequate justice (Squires 119). The legal consequences in two consecutive scandals hardly could bring them down. The absence of a strong enforcer of the already weak accounting regulations in regards to auditor fraud was the direct reason for Andersen’s numerous scandals. They were breaking the law, profiting, and paying minimal fees if and when they were discovered. Greed was rampant and the opportunity to make more fraudulent money was out there. There are many other partnerships in which Andersen definitely took advantage of that opportunity.

Arizona Baptists

Andersen’s next illegal accounting scam dealt with the Baptist Foundation of Arizona. Serving as BFA’s auditor, Andersen failed to realize the company was running a “Ponzi” investment scheme (Bartlett v. Andersen ¶ 1). Such a scheme involved pooling the individual retirement account balances of some 13,000 elderly people into a fraudulent pyramid (Squires 117). The money from new investors was used to pay off older investors but BFA and Andersen got a cut of the profit. After five years of scandal the BFA filed for bankruptcy when its scheme ran out of investors. The SEC was nowhere to be found, but smaller agencies like the Arizona Board of Accountancy eventually stepped in to review financial statements (Squires 118).

Andersen claimed to know nothing about the “Ponzi” scheme, yet in March 2001, it settled out of court after the BFA sued them for misstating the accounting books (Bartlett v. Arizona ¶ 2). How much did Andersen agree to pay in a case where it admits no wrongdoing? $217 million was ordered to be paid to millions of investors (Squires 118). If it had nothing to hide, the Andersen legal team would have stuck it out in court rather than concede $200 million, and ended the investigation. 13,000 grandmothers and grandfathers were duped into investing their retirement funds so that BFA and Andersen would gain financially. Andersen knew the scheme was unethical and illegal, but neglected its duties as an auditor for increased profit. In the end, Andersen was never truly brought to justice. It had reimbursed the investors for some of the money they had failed to protect, but this punishment was not a deterrent for future scandal.

Waste Management

Arthur Andersen had been partners with Waste Management, Inc. for three decades without legal troubles. However, the Nineties led to greed on both sides of the partnership that ended in SEC settlements. Since no strong accounting fraud deterrents were in place, billions of dollars were dishonestly misstated. Former Andersen employees were Waste Management top financial executives and also many incriminating documents vanished (Squires 120). Tragically, this was only the third-largest instance of accounting fraud in which Arthur Andersen was the audit partner. Signing off on a $1 billion income overstatement and veiling $1.7 billion worth of liabilities over six years, the SEC finally stepped in to stop the corruption (Squires 121).

The Securities and Exchange Commission, as we have seen, is quite good at beginning its investigations. Executing justice based on its findings, however, is a different story. Out of court settlements were the only consequences Andersen faced in three consecutive massive accounting scandals. After six years of greedy accounting fraud, Andersen was fined a mere $7 million (Squires 120). The SEC failed to bring criminal obstruction of justice charges against Andersen. It had only warned the firm that “if it were ever involved in a similar case, the consequences would be more severe” (Squires 119). Blatantly neglecting its own duty to prosecute Arthur Andersen, the SEC issued a $7 million dollar fine and a warning (Squires 120). Warnings do not deter future scandal they merely facilitate the opportunity for it to arise. At last, the SEC had sufficient evidence to take down Andersen before it did more to hurt American corporations, yet they failed miserably. Blame for the Enron scandal, the next “similar case,” falls partly upon the lax implementation of punishment by the SEC (Squires 120).

Enron

The Houston energy titan was the ninth largest corporation in America right before all the document shredding had begun (Squires 127). David Duncan led Arthur Andersen’s audit of the Enron Corporation. Personally choosing his audit team, Duncan knew that
in Enron he would be, “handling a potential time bomb” (Squires 127). Enron was a much larger corporation than those previously discussed in this report. Thus, it entailed even more corruption. Enron in the late Nineties was in a constant state of forming partnerships with smaller Special Purpose Entities. These “off-the-books” partnerships were a way to boost financial statements. Enron’s SPEs were illegitimate because they were not true partnerships. Enron owned nearly all the shares of their 3,500 SPEs, in nearly every case more than the 97% that was allowed by law (Squires 9). Andersen overlooked its duties to the investing public and signed off on these partnerships (Letters ¶ 3). It could do this because the government did not have adequate accounting regulations in place.

The main corporate fraud of Enron is analogously explained by Margaret Ceconi, a former Enron employee. She states, “Say you have a food company that makes both hot dogs and ice cream. The hot dog stand is making money, and the ice cream stand is losing money. So the company puts the ice cream losses on the profitable hot dog books...since the ice cream stand and the hot dog stand have the same owner, is this legal?” (Squires 9)

Such a practice is most definitely illegal, the only legal practice would be to write two sets of books and transfer some funds from hot dog to ice cream stand. However, Andersen allowed Enron to do the illegal version of the practice repeatedly. For example, Andersen allotted $1 billion in losses onto just one of the SPEs in which Enron owned more than the legal 97% interest in. Andersen also failed to stop Enron when they sold so-called “energy contracts” which were actually illegitimate loans (Squires 9).

This deception worked for Andersen until 2001. The first-quarter earnings did not match the Enron-Andersen partnership. On October 16th Enron absorbed a one-time loss of $1 billion and admitted it had not stated $618 million in losses (Squires 8). Immediately in an all-night frenzy of paper shredding and electronic deletion, Andersen strove to wipe out the records of accounting fraud that dated back years (Letters ¶ 2). Its actions were similar to the Sunbeam example, Andersen allotted $1 billion in losses onto the ice cream stand and the hot dog stand have the same owner, is this legal? (Squires 9)

The ensuing SEC investigation into Enron was caught up with the elusive Arthur Andersen, and the government decided Andersen's record was too egregious to ignore, so they treated it as a repeat offender. The negotiations failed and Andersen was indicted” (Fowler ¶ 19).

Their later Enron punishment was a $500,000 fine and five-years of probation (Fowler ¶ 1). However, the government failed to shut Arthur Andersen down. The SEC was on the right track getting closer to stopping Andersen, yet would be duped yet again. After Enron it allowed this repeatedly unethical firm to have one last chance to deceive investors and to break the law. While the Grand Jury was indicting them for obstruction of justice at Enron, another larger scandal was about to erupt.

**WorldCom**

St. Louis telecommunication giant WorldCom “prove[d] to be the final nail in the coffin,” for its auditor Arthur Andersen (Treasor ¶ 1). WorldCom filed for bankruptcy in 2002, making it the largest U.S. filing in history—dwarfing that of Enron. Arthur Andersen withheld crucial financial statements for years leading up to the bankruptcy. After admitting to misstating $3.85 billion, the SEC investigated just how much of a suspected $408 million in loans was part of a cover-up. Obviously not learning anything and acting out of greed, Andersen auditors looked the other way as debts were underscored and assets were upgraded (Associated ¶ 7). Andersen withheld crucial accounting figures to increase the revenues it gained from consulting and started to shred documents once again before it was caught. The destruction ended in August 2002 when the firm had lost its license to audit on the market (Fowler ¶ 12). The SEC had finally caught up with the elusive Arthur Andersen, and the firm completely crumbled in the wake of their investigation into WorldCom (Associated ¶ 3, Squires 149).

**Immediate Changes**

It took more than five years and over five billion dollars in scandalous accounting before the American Government stopped Arthur Andersen. This travesty, however, led to changes in our legal stance on corporate fraud. President George W. Bush immediately increased the SEC’s budget after the Enron Scandal (Squires 150). A 77% augmentation, $766 million annually would go towards stopping future malevolence. In 2002, William H. Donaldson was named the new head of the Commission. He plans to upgrade the technology and hire a significantly larger legal staff in the hope of restoring
investor confidence to the American public (Squires 151).

Throwing money at the problem, however, will not deter any future scandals. The real reforms came in the passing of the 2002 Sarbanes-Oxley Act (Davis 16). Sarbanes-Oxley was a direct response to Enron and WorldCom, finally ensuring quality auditing for all publicly held companies (Squires 151). An extremely concise summary involves an actual auditor combining forces with the CEO, CFO, and a five member board of CPAs and outside attorneys (for example, the District Attorneys). All five will take on greater responsibilities and their work will be overseen by a new organization (Davis 16). Replacing the old self-regulatory ways of the accounting industry, Sarbanes-Oxley set up the Public Company Oversight Board, or PCOB (Squires 151). Finally the government has established reputable authorities in the accounting industry that could help the auditing process. All of the failures of the past five years may be prevented from happening in the near future (Davis 16).

**Was Andersen's Fraud Destined to Happen?**

The rebuttal to the belief that the Government failed to stop Andersen before nearly all investor confidence had been shaken is that there was nothing the government could have done. Accounting legislation similar to Sarbanes-Oxley might never have been passed after, for example, Sunbeam, because it was not urgent. We know that new laws often fail to even reach the Congress and if they do, deliberation on issues can take months at a time. Perhaps a post-Enron Sarbanes-Oxley is something we should be glad to have had passed at all. Necessity to establish accounting regulations in the wake of Enron may have been the only thing that would've ever caused the law to be enacted.

**Was the fraud inevitable?**

The once ultra-reputable Arthur Andersen had lost almost a century's worth of its respect in the accounting world in less than one fraudulent decade. The greed of Arthur Andersen led it to repeatedly break the ethics of accounting and law. The American government allowed this fraud to happen while the self-regulating accounting industry could not bring down this rogue firm. From the Arizona Baptists to WorldCom, Andersen had ripped through the confidence of many American investors for over five years. Billions of dollars were lost by both shareholders and employees. Not enough had been done to stop Andersen before Enron; because too little authority had been placed in the hands of the POB and the SEC. The Sarbanes-Oxley Act was enacted much too late—we allowed many of Andersen’s rampant misdeeds to continue far too long and were for over five years unable to curtail their fraudulent accounting practices.

At least stronger legislation has finally been implemented, and Arthur Andersen is no more. Still, one can only hope that another rogue accounting firm in the future does not exploit the government in the future. Upon researching the Andersen accounting scandal one asks themselves a profound question on commerce. Does greed make fraud inevitable? Perhaps, yet it is up to the government to step in and punish corporations and protect investors and the economy.
Works Cited


