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# From Grace to Disgrace: the Rise & Fall of Arthur Andersen

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**Abstract**. In June 2002, Arthur Andersen LLP became the first accounting firm in history to be criminally convicted. The repercussions were immense. From a position as one of the leading professional services firms in the world, with 85,000 staff in 84 countries and revenues in excess of $9 billion, Andersen effectively ceased to exist within a matter of months. Although Andersen's conviction related specifically to a charge of obstructing justice, public attention focused on the audit relationship between Andersen and its major client, Enron Corporation, particularly the actions (and inactions) that had allowed Enron to post spectacular year-on-year earnings and profit growth. As well as examining events leading up to the demise of Andersen, the case provides an opportunity to consider the broader controversy over accounting and corporate governance practices and, more generally, the pressures found within organisations that can foster unethical conduct. The case was prepared from public sources.

**Keywords:** accounting ethics, auditing, conflicts of interest, normative ethics, ethical decision making, corporate governance, auditor role and responsibilities.

## 1. Introduction

On 15 June 2002, Arthur Andersen LLP ("Andersen") made history by becoming the first accounting firm to be convicted of a felony when a United States district court jury found the firm guilty of obstruction of justice. The conviction related to events that had taken place between October and November 2001, both prior to and immediately following notice of an impending Securities & Exchange Commission ("SEC") investigation into Andersen's former star client Enron. These events included:

1. Michelle Quirk, MBA (Dist.) prepared this case from public sources under the supervision of N. Craig Smith, Associate Professor of Marketing & Ethics, as a basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. The authors gratefully acknowledge the guidance provided on accounting standards by Ronnie Barnes, Assistant Professor of Accounting at London Business School.

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- The large-scale destruction of Enron-related documents which Andersen publicly announced had taken place (the original subject of the indictment) [2], and

- An internal e-mail sent by an Andersen lawyer suggesting specific alterations be made to a memo relating to earnings advice given to Enron (see Exhibit 1). This memo was a key determinant of Andersen's ultimate conviction.

It was not the first time Andersen had found itself in legal trouble. Indeed, over the preceding years, each of the Big Five accounting firms had been ordered to pay out millions of dollars to settle shareholder lawsuits filed as a result of lost value from accounting restatements (see Exhibit 2 for a summary of the largest such settlements). However, it soon became apparent that the SEC regarded Andersen as a 'serial offender' and, in the face of public (and political) outcry following Enron's collapse, was determined to make an example out of Andersen.

Enron's own problems had become evident on 16 October 2001, when the company announced it was taking a $544 million after-tax charge against earnings related to one of its off-balance-sheet partnerships (a partnership created and managed by Enron's CFO, Andrew Fastow) and was reducing shareholders' equity by $1.2 billion (Enron's reported total assets in 2000 were $66 billion). On 22 October, the SEC opened an inquiry into possible conflicts of interest related to dealings between Enron and its subsidiary partnerships. This inquiry was upgraded to a formal investigation on 31 October. In November, Enron further announced that it was restating its accounts for the period 1997-2001 due to accounting errors relating to transactions with other off-balance sheet entities. Enron's downward spiral continued and on 2 December 2001, Enron filed for protection from creditors and became the largest corporate bankruptcy in U.S. history.

The impact of Enron's collapse was both profound and widespread: Enron's share price plunged from a 52-week high of $43 on August 13, to less than $1 by the end of 2001[3]; thousands of Enron employees were left facing retirement without retirement funds; questions were raised about Enron's political connections with the Bush administration and the Blair government; and global banks, investment analysts, and industry 'experts' found their reputations seriously tarnished as their involvement in the affair was discovered.

In turn, Andersen's indictment and subsequent conviction in the wake of Enron's collapse effectively rang the death knell for one of the largest and most

2. Grand Jury Indictment CRH 02 121: *U.S.A. v Arthur Andersen LLP*.
3. Big Charts, ENRNQ Chart, at http://bigcharts.marketwatch.com.