The collapse came swiftly for Enron Corp. when investors and customers learned they could not trust its numbers. On Sunday, six weeks after Enron disclosed that federal regulators were examining its finances, the global energy-trading powerhouse became the biggest bankruptcy in U.S. history.

Like all publicly traded companies in the United States, Enron had an outside auditor scrutinize its annual financial results. In this case, blue-chip accounting firm Arthur Andersen had vouched for the numbers. But Enron, citing accounting errors, had to correct its financial statements, cutting profits for the past three years by 20 percent -- about $586 million. Andersen declined comment and said it is cooperating in the investigation.

The number of corporations retracting and correcting earnings reports has doubled in the past three years, to 233, an Andersen study found. Major accounting firms have failed to detect or have disregarded glaring bookkeeping problems at companies as varied as Rite Aid Corp., Xerox Corp., Sunbeam Corp., Waste Management Inc. and MicroStrategy Inc.

Corporate America's accounting problems raise the question: Can the public depend on the auditors?

"Financial fraud and the accompanying restatement of financial statements have cost investors over $100 billion in the last half-dozen or so years," said Lynn E. Turner, who stepped down last summer as the Securities and Exchange Commission's chief accountant.
The shareholder losses resulting from accounting fraud or error could rival the cost to taxpayers of the savings-and-loan bailout of the early 1990s, he said. Enron investors, including employees who held the company's stock in their retirement accounts, lost billions.

Accounting industry leaders deny they are to blame. They say that the number of failed audits is tiny in relation to the many thousands performed successfully, and that it's often impossible for auditors to see through a sophisticated fraud.

"The industry's record is strong," said Stephen G. Butler, chief executive of KPMG LLP. "I think the fundamental question is: Will you ever get to the point where there are not audit failures? In my view, you won't, just as you won't get to a point where there are no airplane crashes or no automobile crashes, no matter what the safety design or procedures."

The federal government gave the accounting industry the valuable franchise to audit companies that sell shares to the public after the stock market crash of 1929. In return, auditors are supposed to do their best to make sure investors can trust corporate financial statements.

With more than half of the nation's households owning stocks -- directly or through pension or mutual funds -- and a stagnant economy depressing stock values, the investing public has never needed a diligent accounting profession more.

The American system of accounting is still the gold standard for the world. In recent years, the U.S. accounting industry has changed markedly, consolidating into a handful of firms that have become global financial consultants. Known as the "Big Five," Arthur Andersen, Deloitte & Touche LLP, Ernst & Young, KPMG and PricewaterhouseCoopers audit most of the companies whose shares trade on the nation's stock markets.

Licensed professionals are expected to do more than just make sure the numbers add up. They are supposed to check inventory, contact customers and perform other tests before putting their stamp of approval on reports that fairly present the company's financial results.

Increasingly, the way these firms do business is at odds with the accounting industry's public watchdog mission.

* Major accounting firms often make more money from selling clients advice than they do from auditing their books. The accounting firms help businesses pick computer systems, lobby for tax breaks, even evaluate takeover targets. Auditors have been graded and rewarded based on how much other business they win from their audit clients. Arthur Levitt Jr., the former chairman of the SEC, which polices public companies, has argued that such incentives could tempt accountants to go easy on an audit.

* Auditors frequently leave their watchdog positions for jobs at the companies they audit. This career path can encourage auditors to make improper compromises, the SEC has warned. The route is so popular that auditors often find themselves dealing with former colleagues who are now their clients' executives.
* The profession has sought to insulate itself from responsibility for false or fraudulent accounting. When things go wrong, firms typically decline to answer for their work, invoking client confidentiality.

* The system can discourage thoroughness. The fees companies pay their auditors are often set in advance, so the accounting firms' profit margins can diminish as their efforts increase. There are signs that accounting firms are putting fewer resources into audits, using inexperienced staff or skimping on records checks.

These developments compound the more basic, underlying conflict: The auditors are hired, fired and paid by the companies they are responsible for auditing.

"Too often, they operate under the principle that the customer is always right," said Nell Minow, an activist money manager and editor of the Corporate Library, a Web site on corporate governance. "They will give the answer that the customer wants . . . so they can continue to get the fees."

Investment billionaire Warren E. Buffett put it this way in 1999: "Though auditors should regard the investing public as their client, they tend to kowtow instead to the managers who choose them and dole out their pay." Buffett quoted a proverb: "Whose bread I eat, his song I sing."

The new SEC chairman, Harvey L. Pitt, a lawyer who has represented the accounting industry, dismissed Buffett's observation as "a good sound bite" and "a nice thing for people who want to attack a profession to say." What prevents such obsequiousness, he said, is that "if an accounting firm has a reputation for being independent, for being professional and for doing its job, then everybody will flock to that firm."

Robert Kueppers, head of Deloitte's national office, said he and his colleagues know their highest priority: "The culture that I grew up with 25 years here is, your first responsibility is to get the audit done and get it done right."

Last year, an industry panel on audit effectiveness found that "both the profession and the quality of its audits are fundamentally sound."

Accounting firms cite a number of reasons for the rise in corrections. It's tough to apply standards that are nearly 70 years old to the modern economy, they say. And the SEC has made matters worse by issuing new interpretations of complex standards. "The question is not how does this reflect on the auditors," Arthur Andersen said in a written statement. Instead, the firm asked: "How is it that auditors are able to do so well in today's environment?"

'Public Watchdog' Function

In a 1984 ruling, the Supreme Court declared that auditors have an overriding duty to protect the public interest. "This 'public watchdog'
function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust," the court said.

The leading industry trade group, the American Institute of Certified Public Accountants (AICPA), encouraged auditors to take a broad view of their role in a 1999 publication titled "Make Audits Pay: Leveraging the Audit Into Consulting Services." The book says the auditor should think of himself as a "business adviser" and promote his accounting firm's consulting services because "intense competition has reduced the audit to a mere commodity that is distinguishable to the consumer only according to price."

The book notes that "conflicts may arise" in asking the auditor to perform two roles that are inherently at odds. "The business adviser is a client advocate," responsible for "acting in the owner's best interests." That is "completely different from the professional skepticism required of the auditor," the book says. But it suggests the conflicts are manageable if the auditor errs on the side of looking out for the public interest.

A case study posted on Arthur Andersen's Web site under "Success Stories" shows how the firm sees itself. As auditor for TheStreet.com Inc., a financial news service, Arthur Andersen said, it helped its client prepare for an initial public offering of stock, develop a global expansion strategy and secure a weekly television show through another client, News Corp.

One of Arthur Andersen's "greatest strengths . . . is developing full-service relationships with emerging companies and then using all of our capabilities to find inventive ways to help them continue to grow," auditor Tom Duffy is quoted as saying.

TheStreet.com chief executive Thomas J. Clarke Jr. said the accounting firm "become[s] a business partner because they're right there with you." He said the auditors answer to a committee of outside board members, not TheStreet.com executives, to provide checks and balances.

Within the accounting business, consulting is widely viewed as more glamorous and lucrative than auditing. The SEC's Pitt said the profession has faced "some difficulties in attracting the best and the brightest."

Among the Big Five firms, U.S. consulting revenue totaled more than $15 billion in 1999 -- about half the firms' total revenue -- the SEC reported last year. That was up from 13 percent in 1981.

The AICPA has described the "certified public accountant" designation as a marketing liability. "The marketplace says the worst thing we have going for us is the 'A' in CPA," Barry Melancon, the trade group's president, wrote in 1998, referring to the word "accountant."

To reflect the variety of services accountants offer, AICPA leaders this fall proposed creating a new credential for "strategic business professionals," and AICPA members have been given until Dec. 28 to vote on the idea.
Fees for non-audit services often eclipse those for audits, according to disclosures corporations were required to begin filing with the SEC early this year. KPMG billed electronics manufacturer Motorola Inc. $3.9 million for auditing and $62.3 million for other services. Ernst & Young billed long-distance phone company Sprint Corp. $2.5 million for auditing and $63.8 million for other services. AT&T Corp. paid PricewaterhouseCoopers $7.9 million for auditing and $48.4 million for other services.

No one has suggested the financial statements of those companies are inaccurate or misleading.

Rite Aid shareholders alleged that consulting fees figured in KPMG's relationship with the drugstore chain, according to their class-action lawsuit against the accounting firm.

Rite Aid acknowledged last year that it had overstated earnings by more than $1 billion over two years. Audit fees were less than 20 percent of what Rite Aid paid KPMG over a 2 1/2-year period in the late 1990s, the suit alleged.

At one point, the suit alleged, Rite Aid's then-chairman, Martin L. Grass, awarded KPMG consulting engagements worth more than $1.5 million "as a sweetener and to ensure the accounting firm's continued cooperation."

An attorney for Grass said the allegations were "wrong" and "grossly unfair." KPMG was given a contract to address weaknesses in Rite Aid's inventory-tracking system, not to ensure cooperation, lawyer Andrew Weissman said.

KPMG said that it was "victimized by company management" and that the consulting it did for Rite Aid was "insignificant to the overall professional relationship."

The pressures on individual auditors to be "rainmakers," luring new business, as well as to be watchdogs, is apparent from documents in another lawsuit, which was decided in 1996. The case involved Coopers & Lybrand accountant Gregory Finerty's work as auditor for another drugstore chain, Phar-Mor Inc., in the late 1980s. When he didn't bring in enough consulting revenue to please his employer, Finerty's performance review and compensation suffered, the documents showed. "Greg was skipped last year . . . but he got the 'message,' " a superior wrote in one review. The next year, the reviewer added, "he bounced back and . . . cross sold over $900,000 of business."

As Finerty sold more consulting services, his reviews improved. "WOW!!! Greg cross-sold $2.5 million in Special Services to his client," his 1991 review said.

"He penetrated 18 of his 21 clients and sold every service line."

Then, massive accounting fraud at Phar-Mor was exposed. The company filed for bankruptcy protection and its chief executive was convicted of felonies.
In 1996 a jury found that Coopers committed civil fraud. Coopers then settled with plaintiffs for an undisclosed amount.

PricewaterhouseCoopers, formed by the 1998 merger of Coopers and Price Waterhouse, told The Washington Post, "We were the victims of a massive, collusive fraud perpetrated by the former management of Phar-Mor."

Finerty, who is no longer with the firm, declined to comment.

Accounting executives say providing consulting services actually improves audits because it helps an accounting firm get to know a client's business better.

"There is no conflict between the auditor's responsibilities and his calling to the client's attention certain other services that may benefit the client," PricewaterhouseCoopers said in a written reply to questions from The Washington Post.

A document from another lawsuit shows that PricewaterhouseCoopers was still monitoring the amount of non-audit services partners generated last year.

Personnel records of Warren Martin, who oversaw the firm's audits of Virginia software maker MicroStrategy, showed he brought in nearly $3.6 million of "other service line revenues" during the 10 months that ended April 30, 2000, compared with a $2 million target for the year.

PwC said it would not comment on personnel matters.

Trust and Discretion

"CPAs must never forget that the 'P' in 'CPA' stands for public -- serving the public and maintaining their trust," former SEC chief accountant Turner said.

Accounting firms say they have not forgotten their public duty and note they have dropped clients or been fired over disagreements with them. They have also forced clients to publicly correct errors.

Last year, Gene Logic Inc., a Gaithersburg biotechnology firm, fired Arthur Andersen, saying it was disappointed with the outside auditor's level of service and cost. Andersen said in a letter included in an SEC filing that, before Andersen was fired, the accounting firm had told the company it thought it was trying to book $1.5 million of revenue from new contracts prematurely. Gene Logic spokesman Robert Burrows said the revenue disagreement had nothing to do with the auditor's dismissal.

Arthur Andersen said it quickly resigned or refused to accept more than 60 auditing jobs last year after its background checks turned up questions about the integrity of the clients' management.

"There have been innumerable cases . . . where people have stood up and refused to go along with improper conduct," SEC Chairman Pitt said.

Accounting firms say their duty to protect client confidences,
based in state law and the profession's code of ethics, prevents them from discussing specific instances where they stood up to their clients and put an end to accounting manipulations.

Citing the same client confidentiality requirements, firms generally refrain from giving a public explanation when a financial blowup leaves investors in free fall.

The board of franchising conglomerate Cendant Inc. commissioned an investigation by outside lawyers and accountants of irregularities at CUC International Inc., one of two companies that merged to form Cendant in 1997. The investigators' 1998 report concluded that CUC had inflated operating income by $500 million over a three-year period, and it accused several insiders of participating in the deception.

But the report made no judgments about the company's longtime auditor, Ernst & Young. As a condition of cooperating, Ernst & Young insisted that the investigation remain silent on the question of whether it had violated professional standards, according to a legal brief filed on behalf of investors.

Ernst & Young later paid $335 million to settle with CUC shareholders who had sued it. Two former CUC executives who previously worked for Ernst & Young pleaded guilty to criminal charges.

The accounting firm said it was "the victim of intentional, collusive fraud on the part of CUC's management." The $335 million payment was not an admission of wrongdoing, the firm added, saying such settlements are "sometimes the only realistic option."

The accounting industry has long resisted the idea that auditors should be responsible for exposing fraud.

"We don't want to be in the business of being fraud detectors," Philip Laskawy, who retired in June as chief executive of Ernst & Young, told The Washington Post in the mid-1990s. "What we would like to believe . . . is that you're dealing with honest and reliable people."

A standard adopted by the profession since then requires auditors to assess the risk that fraud is occurring and tailor their audits accordingly.

Since 1995, auditors are also required to notify the SEC if they learn of illegal acts that corporate managers have failed to remedy. Then-SEC enforcement director Richard H. Walker said in a speech last December that the agency received "fewer than five" such notices during the preceding year and fewer than a dozen before then.

Rep. John D. Dingell (D-Mich.), who has sparred with accounting firms before, wondered if the sparse reports meant the auditors are "missing in action." Accounting firms said they expected only a small number of reports, partly because the requirement is triggered only if, in their opinion, an illegal act has "a material impact on the financial statements."

Though investors may interpret an auditor's certification as a sign that financial statements are accurate, accounting firms say their
Audits are intended to provide only "reasonable assurance" that financial statements are free of "material misstatement."

Over the years, auditors have overlooked a variety of problems and warning signs on the grounds that they were not big enough to be considered "material."

For example, while auditing CUC International, Ernst & Young concluded that after-tax income for one month was overstated by $23 million. But the auditor concluded that the $23 million problem and other discrepancies were not material, according to a report Cendant filed with the SEC. In answer to questions from The Post, Ernst & Young responded generally that even the best audits cannot detect fraud.

Later, after CUC merged with HFS Inc. -- the company behind such famous brands as Avis, Days Inn and Century 21 -- the leadership of the new corporation announced that it had discovered "potential accounting irregularities" and that previously issued auditors' reports "should not be relied upon." The value of the combined company's stock sank by billions of dollars.

Standards and Practices

The basic requirements of an audit include checking a company's inventory and verifying transactions with a sampling of customers. But professional standards, set by an AICPA board, give accountants broad discretion as to what to do in an audit.

"The auditing standards are so general that, as a practical matter, it's difficult to hold anyone accountable for not following them," said Turner, the former SEC chief accountant.

Even so, a report by an accounting industry review panel last year cited a "gap" between auditing standards and "what actually transpires in practice."

The Panel on Audit Effectiveness, which was led by a former chairman of Price Waterhouse, warned that "audit firms may have reduced the scope of audits and the level of testing." The panel called for heightened testing to better detect fraud.

While accounting firm managers constantly send their auditors messages on topics such as client service, client relationships and profitability, such guidance "often only indirectly infer that quality audit work is an integral part of quality client service," the panel said.

When CFO magazine, a publication for financial executives, surveyed 75 chief financial officers last year, 18 percent called their auditors "extremely thorough," but 23 percent rated them "not thorough enough."

Some industry veterans say audits have become loss leaders -- a way for firms to get their foot in a client's door and win consulting contracts.
Arthur Andersen disagreed, telling The Post that audits are among the more profitable services the firm provides, adding that "lower pricing in some years" is "made up over time."

Indeed, accounting firms say that if the audit becomes more complicated than initially expected, their contracts generally allow them to go back to their clients and adjust the fee.

In a long-running lawsuit, Calpers, the giant pension fund for California public employees accused Arthur Andersen of doing such a superficial job auditing a finance company that the "purported audits were nothing more than 'pretended audits.'"

Andersen assigned a young, inexperienced auditor "who has candidly testified he did not even know what a Contract Receivable was, then or now," consultants for Calpers wrote in a September 2000 report prepared in support of the lawsuit.

Andersen didn't test any of those accounts while the unpaid balances soared, and it failed to recognize that a substantial amount was uncollectible, the report said.

Andersen declined to comment on the case, which was settled confidentially.

Potential Conflicts

Just as government officials often take jobs in the industries they are responsible for regulating, outside auditors often go to work for their clients.

The AICPA board of directors in 1993 proposed a cooling-off period before lead auditors could go to work for their clients, but the SEC last year decided that approach "unnecessarily restricts . . . employment opportunities."

Investors in MicroStrategy lost billions of dollars, at least on paper, when the Northern Virginia software company announced in March 2000 that, contrary to years of audited financial statements, it had been losing money rather than making a profit.

Months before the correction, while serving as senior manager on the MicroStrategy audit, a PricewaterhouseCoopers accountant sought a job as chief financial officer of a MicroStrategy subsidiary, according to a report filed by plaintiffs in a shareholder lawsuit against the accounting firm. The report cited an Aug. 6, 1999, e-mail from the auditor to a MicroStrategy executive, saying, "As we discussed I would really appreciate the opportunity to have a shot at the CFO spot in the new company."

PricewaterhouseCoopers said this had "no impact on the quality or integrity of the audit." The accounting firm denied wrongdoing and said it agreed to pay a $51 million settlement "to avoid the further costs and uncertainties of protracted litigation."
Few cases illustrate the potential conflicts in the accounting business as vividly as the one involving Arthur Andersen and Waste Management.

Many investors may not realize they were victims because they held Waste Management stock indirectly, through mutual funds and retirement plans. Lolita Walters, an 80-year-old retired New York City government employee who suffers from diabetes and a heart condition, can count what she lost -- more than $2,800, enough money to pay for almost a year of prescription drugs.

"I think it's unconscionable," Walters said of Andersen's role.

According to the SEC, Andersen lent its credibility to Waste Management's annual reports even though it had documented that they were deeply flawed.

Waste Management eventually admitted that, over several years, it had overstated its pretax profits by $1.4 billion.

In a civil suit filed in June, the SEC accused Arthur Andersen of fraud for signing off on Waste Management's false financial statements from 1993 through 1996. For example, during the 1993 audit, the SEC said, the auditors noted $128 million of cumulative "misstatements" that would have reduced the company's earnings, before including special items, by 12 percent. But Andersen partners decided the misstatements were not significant enough to require correction, the SEC said.

An Andersen memorandum showed the accounting firm disagreed with the approach Waste Management used "to bury charges" and warned Waste Management that the practice represented "an area of SEC exposure," but Andersen did not stop it, the SEC said.

An SEC order noted that, from 1971 until 1997, all of Waste Management's chief financial officers and chief accounting officers were former Andersen auditors. The Andersen partner assigned to lead the disputed audits coordinated marketing of non-audit services, and his compensation was influenced by the volume of non-audit fees Andersen billed to Waste Management, the SEC said.

Over a period of years, Andersen and an affiliated consulting firm billed Waste Management about $18 million for non-audit work, more than double the $7.5 million it was paid in audit fees, which were capped, the SEC said. Andersen said some of the non-audit work was related to auditing.

Andersen, which continues to serve as Waste Management's auditor, agreed to pay a $7 million fine to the SEC, and joined with Waste Management to settle a class-action lawsuit on behalf of shareholders for a combined $220 million. Andersen did not admit wrongdoing in either settlement.

"There are important lessons to be learned from this settlement by all involved in the financial reporting process," Terry E. Hatchett, Andersen's managing partner for North America, said in a statement after the SEC action. "Investors can continue to rely on our signature with confidence."
Staff writer Sandra Sugawara and researcher Richard Drezen contributed to this report.

Tomorrow: The accountants' accountability

Lolita Walters, 80, says Waste Management's problems cost her $2,800. Former SEC chief accountant Lynn E. Turner stresses the "P" in "CPA." Lora Ellis, left, was among the employees laid off after Enron, wracked by accounting questions, filed for bankruptcy.
Three years ago, as the bull market roared toward a rendezvous with reality, Arthur Levitt Jr. sounded an alarm.

In the financial reports that companies issue to tell investors how they are performing, "integrity may be losing out to illusion," Levitt, the Clinton administration's Securities and Exchange Commission chairman, declared. As Levitt saw it, too many outside auditors were joining corporate executives "in a game of winks and nods."

Levitt made accounting manipulations a prime target of SEC enforcement, and his staff issued strict guidance to accountants. Those efforts prompted many corporations to correct numbers from past earnings reports.

Convinced that outside auditors had become beholden to the companies they audit, Levitt tried to prohibit accounting firms from serving as information technology consultants to their audit clients. He argued that the value of the consulting contracts could make auditors hesitate before challenging clients over dubious bookkeeping.

Bitterly opposed by three of the Big Five accounting firms and the American Institute of Certified Public Accountants (AICPA), Levitt ultimately settled for a requirement that corporations disclose how much they pay accounting firms for auditing and other services.

Looking back now, Levitt said in a recent interview, he wonders whether he should have done more -- such as pushing for a federally chartered oversight body for auditors that would be answerable to the government.
This year, President Bush chose a new SEC chairman: Harvey L. Pitt, a Washington securities lawyer and former SEC general counsel who has represented each of the Big Five accounting firms and the AICPA, same trade association that locked horns with Levitt.

Addressing industry leaders recently, Pitt promised "a new era of respect and cooperation."

Pitt and a colleague, in a 1998 journal article, argued the industry's position that "the performance of nonaudit services can improve the audit function."

Interviewed last month, Pitt said he was troubled by the rise in corporate accounting corrections, which "in a philosophical way . . . all reflect on auditors." The shock of a correction "undermines confidence in our system" and "unfortunately subjects public investors to really enormous potential losses," he added.

But Pitt said the SEC has contributed to the problem by punishing accounting judgments that were made in good faith. He said accountants have worried that if they approach the SEC, "they will be slammed for whatever they reveal."

"I think that there have been instances where what the agency has done is focus more on an after-the-fact casting of blame and aspersion than on figuring out how to protect investors," he said.

"We aren't going to play 'Gotcha,' " he pledged.

Pitt said he will make the SEC a more hospitable place for accountants to seek guidance, so the agency can address issues in advance and avoid the need for corrections.

Pitt complained that SEC enforcement actions may accomplish nothing for investors when they come long after the damage has been done. He said his goal will be to help investors in "real time," not to grab headlines, and he is offering leniency in return for cooperation. But he also said he wouldn't hesitate to wield the full power of the SEC in cases of fraud.

Pitt noted that he has years of experience defending people against the SEC.

"I know where the bodies are buried, and I also know where the weak points are," he said.

-- David S. Hilzenrath
John A. LaBarca was supposed to look out for the investors.

Starting in the mid-1980s, he oversaw the outside audits of JWP Inc., an obscure New York company that bought a string of businesses and transformed itself into a multibillion-dollar conglomerate. The job required LaBarca, a partner at the big accounting firm Ernst & Young LLP, to scrutinize the work of JWP's chief financial officer, Ernest W. Grendi, a running buddy and former colleague.

In 1992, a new president at JWP discovered rampant accounting manipulations, and the company's stock sank. When the numbers were corrected, the 1991 earnings were slashed from more than $60 million to less than $30 million.

After hearing extensive evidence in a bondholders' lawsuit, a federal judge criticized "the seeming spinelessness" of LaBarca.

"Time and again, Ernst & Young found the fraudulent accounting at JWP, but managed to 'get comfortable' with it," Judge William C. Conner wrote in a 1997 opinion. "The 'watchdog' behaved more like a lap dog."

Today, LaBarca is senior vice president of financial operations and acting controller at the media conglomerate AOL Time Warner Inc., where his duties include overseeing internal audits.

The Securities and Exchange Commission filed and settled fraud charges against Grendi but took no action against LaBarca. Neither did the American Institute of Certified Public Accountants (AICPA), a 340,000-member professional organization charged with disciplining its
own, or the state of New York, which licensed LaBarca.

LaBarca declined to discuss the JWP case but maintained during the trial that the accounting was "perfectly within the guidelines."

An Ernst & Young spokesman said the firm was confident it upheld a tradition "of integrity, objectivity and trust." Grendi declined comment.

A Washington Post analysis of hundreds of disciplinary cases since 1990 found that, when things go wrong, accountants face little public accountability.

"The deterrent effect that's necessary is just not there," said Douglas R. Carmichael, a professor of accountancy at the City University of New York's Baruch College. That "makes investing like Russian roulette," he added.

In theory, the system has several complementary layers of review. In practice, it is undermined by a lack of resources, coordination and will.

The SEC can bar accountants from auditing publicly traded companies for unprofessional conduct. The agency, however, has the personnel to investigate only the most egregious examples of auditing abuse, officials say. It typically settles its cases without an admission of wrongdoing, often years after the trouble surfaced.

Between 1990 and the end of last year, the SEC sanctioned about 280 accountants, evenly divided between outside auditors and corporate financial officers, The Post's review found.

The AICPA can expel an accountant from its ranks, which can prompt the accountant's firm to reassign or fire him. The trade group took disciplinary action in fewer than a fifth of the cases in which the SEC imposed sanctions, The Post found. About one-third of the accountants the SEC sanctioned weren't AICPA members and thus were beyond its reach.

Even when the AICPA determined that accountants sanctioned by the SEC had committed violations, it closed the vast majority of ethics cases without disciplinary action or public disclosure.

President Bill Clinton's SEC chairman, Arthur Levitt Jr., a frequent critic of the industry, said the AICPA "seems unable to discipline its own members for violations of its own standards of professional conduct."

The membership group works as a lobbying force for accountants and often battles SEC regulatory efforts.

State regulators have the ultimate authority. They can take away an accountant's license. But some state authorities acknowledge that their efforts are hit-or-miss.

"We only find out about violations on the part of regulants [licensees] in two ways: One, somebody complains, or two, we get lucky," said David E. Dick, assistant director of Virginia's Department of
Professional and Occupational Regulation, which until recently administered discipline for the state's accountants.

When the SEC settles without a court judgment or an admission of culpability, state authorities must build their case from scratch, said regulators in New York, where many corporate accountants are licensed.

"You could probably fault both state boards and the SEC for not having worked cooperatively enough with one another over the years," said Lynn E. Turner, who stepped down this summer as the SEC's chief accountant. He added that the agency has tried harder over the past year and a half to share investigative records with state regulators.

As of June, the state of New York had taken disciplinary action against about a third of the New York accountants The Post culled from 11 years of SEC professional-misconduct cases.

While prosecutors occasionally file criminal charges against corporate officials in financial fraud case, they hardly ever bring criminal cases against independent auditors, in part because the accounting rules are so complex. The AICPA's general counsel could recall only a handful of prosecutions.

"From my perspective, this was very hard stuff," said a federal prosecutor who investigated a major accounting fraud. "The prospect of litigating a case against people who actually do this stuff for a living and at least in theory are the world's experts . . . is a daunting prospect."

Investor lawsuits sometimes lead to multimillion-dollar settlements. But they rarely shed light on the performance of individual auditors because accounting firms generally get court records sealed and settle before trial, limiting public scrutiny.

The accounting firms say they discipline those who violate professional standards, including removing them from audits or terminating their employment.

Barry Melancon, president of the AICPA, said "you cannot look at discipline alone" when assessing accountability in the accounting profession.

The profession's emphasis is on preventing rather than punishing mistakes, he added. Thus, it invests heavily in quality-control efforts, such as periodic "peer reviews" of the paperwork accounting firms generate during audits.

In disciplinary cases, the AICPA's goal is to rehabilitate accountants, not to expel them, officials said. "While it may feel good and it may give somebody something to write about when somebody is disciplined, the most important thing is whether or not this profession does a good job doing audits or not," Melancon said.

The AICPA puts its investigations on hold until SEC enforcement actions and other litigation have run their course, which can take several years.
Acknowledging one of the system's historic weaknesses, the AICPA this year began requiring accounting firms to, at a minimum, supervise senior auditors' work more closely while they are the subject of a pending AICPA ethics case.

"The profession's self-disciplinary process . . . taken as a whole, is reasonably effective in protecting investor interests," the accounting firm Arthur Andersen LLP said in a statement. "As with any system, it can be improved."

A Critic of the SEC
No one has been more critical of the SEC's slow-moving enforcement process than the agency's new chairman, Harvey L. Pitt, a lawyer with long experience defending clients against the SEC.

"If you bring a case six years after a company goes down the tubes, after all of the money has been squandered and dissipated, you are not helping investors," Pitt said.

Pitt is offering leniency in return for prompt cooperation and restitution. He said that could mean forgoing enforcement action in rare cases. But he also said, as violations warrant, "we are going to be every bit as tough as the SEC has ever been, and maybe even tougher."

SEC penalties for unprofessional conduct include temporarily or permanently barring someone from auditing companies whose shares trade on stock markets.

Negotiated settlements remain central to Pitt's enforcement strategy. "There are not enough lawyers in the country for us to hire if we have to litigate all of our cases," he said.

Richard Walker, the SEC's director of enforcement until earlier this year, said before he left that about 70 SEC accountants were working on about 250 enforcement cases involving accounting and financial reporting, and the agency lacked the capacity to pursue every violation.

"We just simply don't have the resources to do that, so we have to be selective and . . . choose cases that have the greatest importance," Walker said.

But even when the agency focuses on a high-priority case, its actions can send mixed signals. In June the SEC alleged that a former managing partner of Arthur Andersen allowed persistent misstatements in Waste Management Inc.'s financial reports to go uncorrected, but the agency took no action against him.

The accounting firm and three lower-ranking Andersen personnel settled SEC fraud charges, without admitting wrongdoing. The firm agreed to pay $7 million; the individual accountants, a total of $120,000.

Walker said the SEC took no action against the former managing partner, who wasn't identified by name, because the agency didn't think he had the "requisite state of mind" or knowledge.
Asked for comment, an Andersen spokesman replied, "The record speaks for itself."

With or without an admission of wrongdoing, an SEC enforcement action for professional misconduct "is the closest thing as you get to a death penalty in the accounting profession," said Charles D. Niemeier, chief accountant in the SEC's enforcement division.

"If the person is a partner in a Big Five firm, they're gone," and "most major companies would not hire a person in any key position" who has an SEC enforcement action on their record, Niemeier said.

That wasn't the case after the SEC ordered Thomas J. Scanlon, a Price Waterhouse LLP partner, to "cease and desist" from violating securities laws in 1999. The agency found that he knew a W.R. Grace & Co. subsidiary had manipulated numbers but failed to insist on proper disclosure.

PricewaterhouseCoopers, as the firm is now known, said the SEC action "speaks for itself."

The order essentially meant that "you don't admit you did anything wrong but you agree that you will not do it again," as Scanlon put it in an interview. Until early this year, Scanlon, now retired, remained the lead PricewaterhouseCoopers partner on the W.R. Grace audit.

Self-Regulator
The accounting profession has long championed its ability to regulate itself, from setting auditing standards to reviewing how well accounting firms follow those requirements. The AICPA, with an ethics division and various oversight committees, stands at the center of that effort.

As early as the 1970s, that effort was under fire. A congressional report in 1977 called for stronger government oversight of accounting, citing an "alarming lack of independence and . . . dedication to public protection."

The report also noted that the AICPA cleared former Nixon administration official Maurice H. Stans of professional ethics charges after he pleaded guilty to criminal charges in the Watergate scandal. Stans had been president of the AICPA and senior partner of a major accounting firm.

The same year an AICPA advisory commission called on the trade group "to conduct the profession's disciplinary actions 'in the sunshine,' " but the AICPA rejected that proposal, according to a history by its past president, Wallace E. Olson.

In 1985 Price Waterhouse, citing a "crisis of confidence in the auditor's effectiveness," broke ranks with other major firms and called for creation of an SEC-supervised self-regulatory organization "with credible disciplinary authority."

Other big accounting firms were furious. "They couldn't believe that [Price Waterhouse] was selling them out, that here was a firm ready to jump in bed with the enemy," said Wade S. Williams, a former lobbyist
for the AICPA and Deloitte & Touche LLP. The proposal died.

Most of the AICPA's ethics work is invisible to the public. When the group finds violations, it routinely resolves cases by issuing confidential letters directing accountants to take "corrective" steps such as courses providing "continuing professional education."

Such private letters have outnumbered by 5 to 1 the suspension or expulsion of members, according to a 1999 AICPA memo to the SEC obtained through the Freedom of Information Act. The memo covered the most recent 108 cases that had been resolved by an AICPA disciplinary panel after SEC action. More extensive data the AICPA gave The Post showed the same pattern.

The AICPA lacks the power to restrict an accountant's practice. But, indirectly, its disciplinary actions can have consequences. If a firm continued to employ a partner expelled from the AICPA, the firm itself could face expulsion, and that could disqualify it from auditing companies listed on the Nasdaq Stock Market and the American Stock Exchange, AICPA officials said.

The Post analysis of AICPA data shows that about 60 percent of the more than 500 members expelled between 1990 and the end of 2000 were ousted automatically, in cases, for example, where they had already been convicted of a crime or stripped of a state license. In more than a quarter of the expulsion cases, members were ousted for refusing to cooperate with AICPA investigations or comply with its remedial orders.

Only about a quarter of the AICPA's disciplinary actions explicitly involved auditing. Others involved such unrelated offenses as failing to file personal tax returns or embezzling from clients.

The main reason the AICPA refrains from disciplining accountants the SEC has punished is that it lacks the power to subpoena evidence, said Norman R. Walker, former chairman of an AICPA disciplinary panel. "Basically we're confined to looking at the [public] record and the information that the [member] is able to provide and willing to provide," he said.

Besides, AICPA officials added, when accountants settle SEC charges without admitting wrongdoing, the enforcement actions don't prove they did anything wrong. The SEC does not share confidential investigative files with the AICPA.

The AICPA allows accountants to put off disciplinary proceedings while other litigation or regulatory actions are pending. The group postpones action because "if we found something, the plaintiff would use it against our member," said Richard I. Miller, the group's general counsel. "We don't think that that's fair."

The postponements have taken an average of nearly three years, and as long as a decade. It has then taken about a year and half, on average, to conclude a case, according to an AICPA memo to the SEC.

An industry review panel led by a former Price Waterhouse chairman reported last year that the profession's disciplinary system "suffers from a number of limitations," adding that AICPA investigations
"typically commence and conclude long after the public's memory of the matter has faded."

The case of Samuel George Greenspan shows how long the process can take.

Greenspan was retained by ZZZZ Best Corp., a California carpet cleaner, to audit financial statements in the mid-1980s. Greenspan relied on a report by a prior auditor named Richard Evans, which ZZZZ Best's management gave him, regulators alleged. But, according to the SEC, the report was a fabrication.

Had Greenspan checked, he would have discovered that Evans didn't exist, the SEC said. Had he bothered to inspect the eight-story building described in the company's second-largest contract, he would have learned that it didn't exist, either, the SEC said. Greenspan never visited any of ZZZZ Best's 15 purported job sites, the agency alleged when it permanently barred him from auditing public companies in 1991.

After Greenspan's audit, ZZZZ Best sold stock, which plummeted when the company was exposed as being rife with fraud.

"I wasn't hired to detect fraud," Greenspan said in an interview. "I was hired to do an audit."

Greenspan said he didn't have the funds to fight the SEC, "but it may be of interest to you that I was also investigated by the American Institute of CPAs and I was exonerated completely." He provided a copy of a 1998 letter in which the AICPA said it found "no prima facie evidence" that he violated its code of conduct and was closing its investigation.

The states of New Jersey and New York, which licensed Greenspan, also said they have taken no disciplinary action against him.

The disciplinary notices the AICPA issues to the public do not include the name of the accountant's firm or the name of the company the accountant was auditing.

A February 1998 report, for instance, listed the names of 15 individuals. It said a trial board had found them guilty of violating the rule that requires auditors to be independent from their clients. Then it concluded, without explanation: "The hearing panel voted there should be no sanctions."

Boards Ill-Equipped

The state licensing boards hold the most power over accountants, but many are ill-equipped to police the profession. "There are a number of state boards that just don't have the financial resources to take on big firms," said Dennis Spackman, past chairman of the National Association of State Boards of Accountancy (NASBA).

For the most part, "the state boards of accountancy are ineffective," said Lloyd "Buddy" Turman, who is executive director of the Florida Institute of Certified Public Accountants, a professional society.
Members of the accounting industry backed legislation in Virginia this year to create a separate state agency for the supervision of the state's 14,000 accountants and remove that function from a department that oversees a variety of professions.

Gov. James S. Gilmore III (R) vetoed the bill, arguing that, "to avoid conflicts of interest, regulatory agencies cannot be dedicated to individual professions." The legislature overrode Gilmore's veto.

Ellis Dunkum, a retired PricewaterhouseCoopers partner who is chairman of the Virginia state board, said the new agency, which operates on a smaller budget, is more efficient because its staff can concentrate on being knowledgeable about one set of regulations.

In Maryland, Dennis Gring, executive director of the state board, said he spends most of his time monitoring the state's 14,000 active accountants. He said he also works for boards regulating foresters, precious metal dealers, sports agents and heating and ventilation contractors.

The AICPA has urged state licensing authorities to let it investigate disciplinary cases on their behalf, partly to avoid duplication of effort. Four states -- Illinois, West Virginia, Rhode Island and Connecticut -- have accepted the group's offer, at least in principle.

AICPA disciplinary notices often give the licensing authorities in Connecticut "our first inkling" of a possible problem, said Michael T. Kozik, staff attorney for the Connecticut board. The board's staff consists of a director, three clerical workers and himself part time -- when he isn't handling election-law matters for the state, Kozik said.

Under the Connecticut-AICPA cooperative agreement, which has been used in only one or two cases, the group shares the results of its investigation and the state makes its own decision, Kozik said. In complicated cases, "it saves us the time and the expense of ... hiring experts," he said.

The state of New York, which had the most accountants sanctioned by the SEC, as of June had disciplined 17 of 49 New York accountants. The Post culled from more than a decade of SEC enforcement actions.

New York regulators said they lack legal authority to discipline accountants who engage in misconduct as corporate officers rather than independent auditors. When an accountant licensed in New York is suspected of committing offenses in another state, New York may wait until the other state investigates, said Daniel Dustin, the board's executive secretary.

California regulators disciplined a large majority of the accountants licensed there who were sanctioned by the SEC, though it wasn't unusual for the penalty to be probation.

The association for state accountancy boards maintains a national database of the disciplinary actions its member boards take. But, like a federal database of sanctioned physicians, it is not accessible to the public.
The database was created for state boards to consult when reviewing license applications from accountants already certified in other states. Denise Hanley, NASBA's director of information services, said members of the public can get information about individual accountants from state boards.

A spokeswoman for the District's board, which supervises 1,100 accountants, said it hasn't revoked an accounting license in the past 15 years. Maryland's Gring said records show nine CPAs lost their licenses since 1990, with a 10th about to be made public. Nancy Taylor Feldman, executive director of the Virginia board, said two licenses have been revoked this year.

Liability Limited
Like other professionals, accountants can be sued, and there have been a series of large settlements involving Big Five firms in recent years. But the industry has lobbied hard and successfully to limit its liability.

Sometimes, even when courts find that auditors knowingly misrepresented a company's finances, damages aren't awarded.

In the JWP case, for instance, LaBarca's firm, Ernst & Young, paid $23.4 million to settle with shareholders -- which the judge called "an extravagantly expensive education in auditing ethics."

But a group of insurance companies that lost about $100 million on JWP bonds has come up empty so far.

When the outside auditors confronted JWP management on accounting questions, Judge Conner wrote, "Grendi almost invariably succeeded in either persuading or bullying them to agree that JWP's books required no adjustment."

"Part of the problem was undoubtedly the close personal relationship between Grendi and LaBarca," who trained together for the New York City Marathon, the judge wrote.

In its defense, Ernst & Young argued that LaBarca and his associates were ultimately convinced that JWP's accounting positions were reasonable or that the earnings overstatements were so small as to be immaterial, the judge wrote.

For all his criticism, Conner found that the accounting distortions were not the reason JWP defaulted on its bonds. In legal jargon, he found no "loss causation."

The insurers have appealed. Lawyers who represented Ernst & Young cited their victory in a law journal article titled "Loss Causation: A Defendant's Secret Weapon." Such arguments, they noted, "can brush aside even the most difficult set of facts against a defendant."

Database editor Sarah Cohen, staff researcher Richard Drezen and research assistant Eddy Palanzo contributed to this report.
Paul J. Argy was a Price Waterhouse LLP accountant assigned to audit a Sterling computer maker named Star Technologies when his principles put him on a collision course with K. Clark Childers, the Price Waterhouse partner in charge of the audit.

In the end, Argy buckled.

That's the way the Securities and Exchange Commission tells the story, illustrating pressures auditors can face from clients and colleagues.

SEC records allege this is what happened:

During the 1989 audit, a senior Star executive clashed heatedly with members of the Price Waterhouse team over various accounting decisions, even calling unsuccessfully for Argy and other auditors to be removed from the job.

The disagreements involved the booking of hundreds of thousands of dollars of assets that could not be located, accounts receivable that had been unpaid for almost five years, and obsolete inventory consisting of computer processors introduced seven years earlier.

Argy, a senior manager at Price Waterhouse who was due to be considered for partnership the following year, tentatively concluded that Star would have to take significant write-downs. But about a week before the audit was finished, he left town on a business trip.

While Argy was away, Childers made "arbitrary and improper compromises" that enabled Star to understake its losses.

When Argy returned, he objected to the results. Childers pressured him to sign off on the audit anyway. Though he disagreed, Argy acquiesced. He also backdated his approvals, making it appear that he completed his review before the audit report was issued, as Price Waterhouse policy required.
In early 1990 the firm's national office received an anonymous memo on its letterhead saying there had been an "audit failure" at Star Technologies. The firm looked into it and, without questioning Argy, concluded the allegation was unsubstantiated. But later, a senior partner talked to Argy and reached a different conclusion.

The accounting firm, now known as PricewaterhouseCoopers, withdrew its seal of approval from Star's 1989 financial statements, and in April 1990, Star corrected the numbers, boosting its annual loss to $7.4 million from $4.4 million.

Star settled with the SEC in 1993 without admitting or denying guilt. The same year, the SEC accused Childers and Argy of "improper professional conduct" and banned them from auditing public companies -- Childers for five years and Argy for 18 months -- before they could apply for reinstatement. The two accepted the sanctions in a settlement in which they neither admitted nor denied the SEC's version of events.

Eight years later, both are licensed in Maryland and Virginia.

The SEC lifted its ban on Argy in 1999. Now a partner at a McLean accounting firm, he declined to comment in detail, though he called the SEC action "completely unjust."

Childers said he no longer audits publicly traded companies. He denied that he pressured Argy to sign off on the disputed audit. He said the state of Virginia and the American Institute of Certified Public Accountants both investigated and took no action.

He agreed to the SEC sanction, he said, because "it drags on, costs a lot of time and money. It wears you down and you settle."
When retirees Kenneth and Judith Balfour decided to invest the bulk of their savings in the Baptist Foundation of Arizona in 1999, they noted that it was audited by one of the nation's leading accounting firms, Arthur Andersen LLP.

That "was one of the selling points," Kenneth Balfour recalled. "Everyone knows Arthur Andersen."

The foundation claimed to pay high interest rates on retirement accounts while helping Southern Baptist ministries. But after the Balfours invested $99,000 they earned from the sale of an auto-lube business, the foundation collapsed and they and thousands of others lost hundreds of millions of dollars.

State regulators allege that the Baptist foundation was perpetrating a fraud and that Arthur Andersen, which signed off on the BFA's financial statements year after year, ignored a series of warning signs. Ultimately, regulators allege, Andersen became "a full participant in hiding the fraud."

An Andersen spokeswoman said it wasn't the auditor's job to find fraud. "We were hired to make sure their books balanced," Linda Rizer said.

To an investigator for the Arizona State Board of Accountancy, the case had a ring of familiarity.

During the 1980s, Arthur Andersen had audited Charles Keating's Lincoln Savings and Loan, which became a symbol of the nation's savings-and-loan crisis when it failed in 1989 at an eventual cost to
The lead partner on Andersen's disputed 1985 audit of Lincoln was Jay S. Ozer, who also served as lead auditor of the Baptist Foundation of Arizona.

Andersen paid tens of millions of dollars to settle claims by federal regulators and private investors over its work for Keating.

Arizona regulators settled for a payment of $562,000 -- and a pledge that each of Andersen's Arizona-based auditors would take 40 hours of continuing professional education. The settlement did not sanction any Andersen auditor by name, and the firm denied that its people had done anything wrong.

A December 2000 report by an investigator for the Arizona board said, "The many readily recognizable similarities lead to the conclusion that violations by Ozer in the 1985 Lincoln audit were essentially repeated in the 1995-1997 BFA audits."

This time, the Arizona board is talking about much stiffer sanctions: In a complaint filed last year, it said Ozer and two other Arthur Andersen accountants could lose their licenses and the firm could be liable for restitution of $600 million.

Lawyers for BFA investors and the state tried to question Ozer about his work at an August deposition, but he invoked his Fifth Amendment right against self-incrimination.

An attorney for Ozer, who retired last year, said he denies the allegations in the Baptist Foundation case and says they will be "hotly contested." As for Lincoln Savings, "neither the Arizona Board of Accountancy nor any other government agency found that Mr. Ozer violated any auditing standards during audits of Lincoln Savings, and no proceedings were ever instituted against him with regard to that matter," attorney Brad D. Brian wrote in a letter to The Washington Post.

In "a long and distinguished career," Brian added, Ozer "earned an outstanding reputation in his field."

Accounting executives have long argued that the threat of legal liability keeps them honest. Arizona regulators, however, allege that as the warning signs at the Baptist Foundation of Arizona multiplied, Arthur Andersen "engaged in a full cover-up."

A woman who resigned from her job as a BFA accounting manager gave an Andersen manager "a detailed road map of the fraud" in a 1997 meeting and warned that a group of employees had concluded that the BFA's senior management was not being honest with the audit firm, regulators alleged. Though the former BFA manager gave Andersen the names of other employees who left the BFA, Andersen made no effort to contact them, the complaint said.

Andersen discounted a tip to its Chicago headquarters alleging fraud at the BFA and it continued to vouch for the foundation after the Phoenix New Times newspaper published a series of articles in 1998.
alleging irregularities at the BFA, according to the complaint.

When BFA lawyers enlisted Andersen to advise the nonprofit foundation on its vulnerability to Internal Revenue Service scrutiny, an Andersen employee spotted potential trouble. The Andersen tax manager drafted an "opinion of exposures" in January 1998 saying "The BIG issue" -- which involved the BFA's claim to tax-exempt status -- "could affect our audit opinion and should be addressed."

Then, an Andersen partner directed that the reference to the "BIG issue" be deleted from the report, according to the state complaint.

Andersen has denied the charges and refused to discuss the case in detail. In a statement to The Washington Post, the firm said "the focus should be on indicted senior BFA leadership who designed a complex scheme . . . to mislead their investors and auditors."

Three BFA insiders pleaded guilty to felonies this spring, and five others -- including the foundation's former president -- are fighting criminal charges.

Michael Piccarreta, a lawyer for the former president, said no fraud took place, adding that the accusers "certainly don't let the truth get in the way of a good story." Piccarreta said everything former president William Pierre Crotts did "was in good faith and in an attempt to benefit the foundation."

When the BFA sought bankruptcy protection in November 1999, it estimated it had no more than $260 million in assets to pay off $590 million of obligations to investors. Authorities tell investors they are likely to recoup less than half of their money over five years as the foundation's assets are liquidated.

With the collapse of their interest-bearing BFA investments, the Balfours said they lost almost half of their income. They have since come out of retirement. Judith, 66, a former high school secretary, has worked as a census worker and a bus dispatcher, and the two of them hit the road for a while to help a relative clear Colorado land of prairie dogs.

Harry Jay Freeman of Sun City, Ariz., 56, and his wife, Nita, lost $140,000 -- the bulk of their life savings -- in the BFA collapse. But he is more anguished over his decision to put his elderly, ailing parents' savings into the foundation, too -- the last chunk just days before the state forced the BFA to stop accepting new investments.

"They're pretty much destitute now," he said.

"How can this happen?" Freeman asked. Arthur Andersen "is supposed to be one of the most respected auditors in the world . . . . I'm a steamfitter, and if I couldn't do my job any better than these folks . . . . I couldn't hold a job," he said.
The big accounting firm Arthur Andersen wasn't just the outside auditor for bankrupt energy trader Enron Corp., it was also the company's internal auditor, Enron said yesterday.

Performing both roles should have put Andersen in a stronger position to catch the problems that ultimately brought down Enron, auditing specialists said. But it also might have weakened the advantage of having two levels of safeguards.

When the outside auditor also does internal auditing, "you have lost not only the checks and balances, you have also lost the voice and perspective of an independent third party," said Lynn E. Turner, former chief accountant of the Securities and Exchange Commission.

Enron filed the largest bankruptcy petition in history last week after disclosing that its financial reports overstated profits back to 1997. Large debts and losses were improperly attributed to separate partnerships and kept off the company's books. As Enron's independent auditor, Andersen vouched for the flawed financial statements.

The accounting revelations fueled a meltdown in Enron's stock price, wiping out billions of dollars of shareholder wealth and thousands of jobs as lenders and customers abandoned the company.

Companies are not required to conduct internal audits, but many do to spot problems and give their management greater confidence. Outside auditors have a different responsibility: to independently scrutinize financial statements and assure the investing public that they provide a fair picture of a company's finances.

In recent years, however, big accounting firms have encouraged corporations to pay them -- instead of corporate employees -- to conduct internal audits.

The Securities and Exchange Commission last year expressed concern that entrusting the external auditor with both responsibilities could
pose conflicts of interest by calling on the external auditor to review its own work. The agency adopted a rule prohibiting outside auditors from doing more than 40 percent of the internal auditing for businesses with more than $200 million in assets. The rule doesn't take effect until next August.

Enron said it checked with the SEC at the outset about its arrangement with Andersen. "Both Enron and Andersen ... concluded that their arrangements fell well within the guidelines prescribed by the SEC," Enron said.

An Andersen spokesman did not respond to questions about the firm's role as internal auditor.

In a prepared statement, Enron defended the arrangement.

"The integrated audit put Andersen in the position to be better informed about Enron. Not only would it have the benefit of audit procedures conducted from the outside, it also would have the benefit of the knowledge gained from serving as the internal auditor."

In a proposal to a Fortune 500 company last year, Arthur Andersen said hiring it to conduct both internal and external auditing offered a variety of benefits, including "greater knowledge sharing" between the two groups of auditors. That "increases team efficiency and overall knowledge about the company," the proposal said.

Andersen listed a "representative sample" of a dozen major companies that used the firm for both purposes, including Enron. It also listed a sampling of many more companies that used other big audit firms for both functions.

The accounting industry lobbied successfully for legislation in the 1990s limiting the liability of outside auditors in class-action lawsuits brought by shareholders. But doubling as an internal auditor could expose an accounting firm to bigger damage claims.

Enron's annual proxy statement filed with the Securities and Exchange Commission said the services Andersen provided, besides auditing the financial statements, included "business process and risk management consulting, tax compliance and consulting, due diligence procedures related to acquisitions or other activities, work performed in connection with registration statements and various statutory or other audits."

In February, Andersen wrote a letter that was included in the company's annual report agreeing that "the system of internal control of Enron Corp. and its subsidiaries ... was adequate to provide reasonable assurance as to the reliability of financial statements and the protection of assets from unauthorized acquisition, use or disposition."
Years before Enron Corp. collapsed, wiping out thousands of jobs and billions of dollars of shareholder wealth, outside auditors from the big accounting firm Arthur Andersen found $51 million of problems in the company's books -- and decided to let them go uncorrected.

While auditing Enron's 1997 financial results, Andersen proposed that the energy company make "adjustments" that would have cut its annual income by almost 50 percent, to $54 million from $105 million, according to testimony Andersen has presented to Congress.

Enron chose not to make those adjustments and Andersen put its stamp of approval on the company's financial report anyway.

Had Andersen refused, some observers say, Enron's tale might have turned out differently. If it had been forced to use more conservative accounting practices, the Houston energy trader might never have risen to be the seventh-largest company on the Fortune 500 with a peak share price of $90. And it might never have drowned in a morass of misleading accounting, the largest corporate bankruptcy in U.S. history, its stock price reduced to less than a dollar.

"Maybe if Andersen had put its foot down a few years ago, then Enron might still be a viable going concern today," said analyst John P. Gavin, president of SEC Insight Inc., which researches corporate accounting for institutional investors.

Last month, after a host of accounting problems caught up with it, Enron corrected its books going back to 1997, reducing four years of audited profits by $591 million. The correction included the $51 million of adjustments that Enron and Andersen long ago concluded were unnecessary.

The disclosure of accounting errors helped plunge Enron into a downward spiral as investors and customers abandoned it, their confidence shattered.
Now, Enron and Andersen face shareholder lawsuits and congressional investigations. The Securities and Exchange Commission and the Justice Department are examining Enron's downfall to see if wrongdoing played a part.

The problems that Andersen spotted back in 1997 have been overshadowed by much larger flaws in Enron's bookkeeping, such as vast debts and losses ascribed to related partnerships that were improperly kept off the company's books.

But the story of the $51 million shows how, time and again, potential warnings of financial disaster have gotten past the outside auditors responsible for scrutinizing Corporate America's books and protecting the investing public.

In testimony to Congress earlier this month, Andersen chief executive Joseph F. Berardino said that, after proposing the $51 million of adjustments to Enron's 1997 results, Andersen decided that those adjustments were not "material." The term "material" means large enough to influence a reasonable investor's judgment and therefore require disclosure.

"Some have asked how adjustments representing almost half of reported net income could have been deemed to be immaterial," Berardino said in written testimony. The answer, he said, is that Andersen looked beyond net income and used a different standard of comparison, "what accountants call 'normalized' income."

The $51 million of proposed adjustments amounted to "less than 8 percent" of normalized income, Berardino said.

Berardino did not say how Andersen computed normalized income or what number it came up with. He said Andersen considered Enron's income for prior years, when the company reported much higher earnings -- $453 million in 1994, $520 million in 1995 and $584 million in 1996.

It made sense to look past the 1997 bottom line because Enron's income of $105 million that year reflected large "nonrecurring charges," he said. A report Enron filed with the SEC said Enron took a $463 million charge in 1997 for "contract restructuring."

Berardino's testimony also showed the flexibility that auditors and corporate managers have brought to accounting decisions. Some companies book adjustments "in the year after the auditor identifies them," he said.

Several accounting and auditing specialists interviewed for this story challenged Andersen's conclusion that the $51 million was not material. They said they were unaware of any basis in accounting principles or auditing standards to use normalized income the way Berardino described.

"The whole logic seems fairly shaky to me," said Bala Dharan, professor of accounting at Rice University in Enron's home city, Houston. "By any stretch of logic, $51 million is a significant, material amount."
"A cynic would say that someone was looking for a way to make something that was otherwise material not material," said Stephen A. Zeff, another accounting professor at Rice.

Douglas Carmichael, a professor of accountancy at the City University of New York's Baruch College and former auditing specialist at the American Institute of Certified Public Accountants, said, "It's very hard for me to see any real justification for not regarding that [$51 million] as material."

If auditors judge materiality by such a "fuzzy, loose concept" as normalized income, "almost anything can become immaterial," said Baruch Lev, professor of accounting and finance at New York University's Stern School of Business.

Asked what accounting rules supported Andersen's approach, Andersen spokesman David Tabolt said normalized income is "not a term that's used in the accounting literature." He said Andersen was looking at the "total mix" of considerations, as the SEC has advised, and he added that Berardino was trying to explain the process in language that laymen and members of Congress could understand.

Even using Berardino's yardstick, some accounting scholars said, a difference of 8 percent would seem to be material.

An Enron spokesman declined to comment.

Records of lawsuits and regulatory actions indicate that, in a series of corporate accounting disasters, the outside auditors privately asked their clients to remedy problematic accounting but then backed down, using the concept of materiality to avoid a showdown.

For example, the SEC has alleged that Andersen auditors identified early problems at two other big companies that later ran into trouble, appliance maker Sunbeam Corp. and trash hauler Waste Management Inc.

According to the SEC, Andersen decided that the problems were not material. At Waste Management, the misstatements at issue totaled $128 million at one point, the SEC alleged.

Much later, Waste Management disclosed that it had overstated several years of pretax profits by $1.4 billion, and the SEC accused Andersen of fraud. Without admitting or denying wrongdoing, Andersen agreed to pay a $7 million SEC fine in June.

The SEC was so troubled by auditors' judgments about what is and isn't material that it issued a bulletin in 1999 warning that "misstatements are not immaterial simply because they fall below a numerical threshold." Even small misstatements can be significant if they mask a company's failure to meet Wall Street expectations, involve an effort to "manage" reported earnings, or enable management to collect incentive compensation pegged to the financial results, the SEC bulletin said.