CAPSTONE CASE STUDY ON ORGANIZATIONAL ARCHITECTURE

Arthur Andersen LLP[1]

Introduction and Overview

It is difficult to find an example of a more spectacular business failure than the recent collapse of Arthur Andersen. Within a few years, Andersen moved from one of the largest professional service organizations in the world to almost complete collapse. The impact of the firm's failure on its employees, customers, investors, and the general public is hard to overstate. Its once proud reputation had been reduced to shambles. Even the President of the United States joked:

> *We just received a message from Saddam Hussein. The good news is that he's willing to have his nuclear, biological, and chemical weapons counted. The bad news is he wants Arthur Andersen to do it.*[2]

The dramatic demise of Andersen (along with the failures of companies such as Enron and Global Crossing) has raised concerns among managers throughout the world. They want to understand what caused the collapse of the company so that they can take actions to avoid similar fates.

Over the years, Andersen's business environment and strategy changed in material ways. Their management responded by making associated changes in their organizational architecture (decision right, performance evaluation, and reward systems). Part 3 of this book has argued that ill designed organizational architectures can result in poor performance and even company failure. An important question is whether Andersen's failure can be traced to inappropriate organizational choices. An even more critical question is whether other managers can learn from Andersen's mistakes. We believe that the answer to both questions is yes.

Our case study begins by summarizing the history and events that led to the collapse at Arthur Andersen. This discussion is followed by a series of questions that ask the reader to analyze the demise of Andersen in the context of the framework introduced in this book. Our purpose is not to present all the relevant analysis ourselves. Rather it is to provide readers with the opportunity for an integrated analysis and capstone discussion of an important business problem that relies on material drawn from across the chapters in Part 3 of this book. It also provides a forum for discussing the root causes of the recent business scandals that have rocked the international business community.

[1]This case study is based on public news accounts, company documents, and press releases. Among the most important sources are Ken Brown and Ianthe Jeanne Dugan, "Sad Account: Andersen's Fall from Grace Is a Tale of Greed and Miscures," *The Wall Street Journal*, June 7, 2002; and a series of articles from the *Chicago Tribune* published in September 2002.

[2]Joke made by President George W. Bush at a dinner talk in January 2002 as quoted in the *MBA Jungle*, December 2002–January 2003, 70.

Arthur Andersen: The Early Years

A 28-year-old Northwestern accounting professor named Arthur Andersen started his own business in 1914. Andersen's strategy was to offer high-quality accounting services to clients—promoting integrity and sound audit opinions over higher short-run profits. Soon after Andersen formed the firm, the president of a local railroad demanded that he approve a transaction that would have lowered his company's expenses and increased its reported earnings. Andersen, who was not sure he could even meet his firm's payroll, told the president that there was "not enough money in the city of Chicago" to make him do it. The president promptly severed his relationship with Andersen. However, Andersen soon was vindicated when the railroad filed for bankruptcy a few months later.

In the 1930s, the federal government adopted new laws to require public companies to submit their financial statements to an independent auditor every year. These regulatory changes, along with Andersen's reputation, helped the firm to grow. During these formative years, the organization continued to promote its "four cornerstones" of good service, quality audits, well-managed staff, and profits for the firm. Quality audits were valued more than higher short-run firm profits. Leonard Spacek, who succeeded Andersen as managing partner in 1947, produced more company folklore when he accused powerful Bethlehem Steel of overstating its profits in 1964 by more than 60 percent. He also led a crusade to motivate the Securities and Exchange Commission to crack down on companies that cooked their books. The yellowing press clippings of his bold efforts were still on display at the company's main training center near Chicago in 2002.

Between 1914 and the late 1980s, "tradition was everywhere" at Arthur Andersen. The firm installed heavy wooden doors at the entrance of all its offices. Andersen employees were known to be "one of a kind"—clean-cut, straightlaced, and dressed in pinstripes. Employees were taught to recite the partnership's motto, "Think straight, talk straight." Auditors were rewarded and promoted for making sound audit decisions. Top management assigned significant decision rights to the central office's Professional Standards Group. This group, which consisted of internal experts, monitored audits and issued opinions on how specific types of transactions should be handled. The objective was to promote consistent and well-reasoned opinions throughout the firm.

Andersen's insistence on quality and high standards enhanced its reputation and promoted consistent growth. Auditors in the firm did not become wealthy in these formative years. However, Andersen partners were well respected within their local communities and earned enough to purchase comfortable houses, nice cars, and memberships at local country clubs. In the late 1960s, a mid-level partner at Arthur Andersen made about $30,000—or $160,000 in today's dollars.

Andersen Enters the Consulting Business

In 1950, an Andersen engineer named Joseph Glickauf demonstrated that computers could be used to automate bookkeeping. This event led to monumental changes in the partnership. In addition to its basic auditing function, Andersen also could help clients automate their accounting systems. The firm launched its new computer consulting business in 1954 when it began providing services to General Electric's state-of-the-art appliance factory near Louisville, Kentucky. Andersen soon developed the largest technology practice of any accounting firm.

During the 1950s and 1960s, the consulting business grew but remained a relatively minor activity compared to Andersen's auditing business. During the 1970s, Andersen's consulting business exploded as the demands for information technology increased. By 1979, 42 percent of Andersen's $645 million in worldwide fees came from consulting and tax work, as opposed to auditing and accounting. Consulting became the leading contributor to Andersen's revenues and bottom line in the mid-1980s.

Family Feud

As Andersen's consulting business continued to grow, tensions within the firm mounted. The consultants, who were contributing more to profits than the auditors, felt that they were subsidizing the audit partners. Consultants began to realize that they were underpaid relative to their market opportunities. Auditing partners resented the fact that the consultants wanted a higher share of the profits. The auditing partners, who controlled the managing board, made few concessions to the consulting partners. In response, a number of the top consultants left Andersen for other firms or to start their own consulting businesses.

Because of mounting tension, the firm separated its consulting and auditing businesses in 1989 by forming a new Geneva-based holding company, Andersen Worldwide (AW). Under the AW umbrella were two subsidiaries, Andersen Consulting (AC) and Arthur Andersen (AA). AC was to focus on providing consulting services to large corporations (primarily in the areas of computer systems integration and business strategy). AA, in turn, would focus primarily on audit and tax engagements. However, AA was allowed to provide consulting services to smaller companies (annual revenues of less than $175 million). The more profitable business was to share part of its profits with the other unit. Compensation no longer had to be the same across consulting and auditing partners. Each unit had significant decision rights over its own business.

Strategic and Organizational Changes at Andersen

The implications for the auditing partners were grim. The traditional accounting business was growing quite slowly due to increased competition and the large number of mergers in the 1990s; auditing quickly was becoming a low margin activity. Despite the long hours, accountants' salaries began lagging behind those of other professionals, such as lawyers and investment bankers. AA accountants particularly resented being eclipsed by their consulting counterparts at AC.

The auditors decided to "fight back." As top partner (at the time) Richard Measelle said, "It was a matter of pride." AA adopted a new strategy that focused on generating new business and cutting costs. AA began evaluating its partners on how much new business they brought to the firm. Superb auditors "who could not get a lick of business" were secure in their jobs in the 1970s, but not in the 1990s. According to Measelle, partners began to feel that "the number one thing was to make your numbers and to make money."

To reduce costs, AA began requiring partners to retire at age 56, enforcing a policy that had long been overlooked. The increased emphasis on revenue growth and expense reduction led to substantially higher revenues and profits per partner. As the twentieth century drew to a close, the average AA partner made around $600,000. However, these new policies also led to less experienced auditors and fewer partners overseeing audits.

A new breed of partner rose to the top within this new environment. One prominent example was Steve Samek, who was in charge of the Boston Chicken audit. Top partners gave Samek high praise for "turning a $50,000 audit fee at Boston Chicken into a $3 million full-service engagement." Samek, however, allowed the chain to keep details of losses at it struggling franchises off its own financial statements as it moved toward an initial public offering. The overstated financial statements helped make the IPO a "rousing success." Boston Chicken's subsequent collapse and bankruptcy led to legal actions against AA for helping to create a "facade of corporate solvency." In 2002, AA agreed to settle these suits by paying $10 million. Samek, however, had left the Boston Chicken account in 1993 to move on to bigger and more important assignments.

Robert Allgyer was known within AA as the "the Rainmaker" due to his success at cross-selling services to audit clients. One of his biggest "successes" was Waste Management, which paid $17.8 million in nonaudit fees to AA between 1991 and 1997, compared to $7.5 million in audit fees. At the same time, Allgyer was signing off on inaccurate financial statements. Among other things, the company wasn't properly writing off the value of its assets such as garbage trucks as they aged. As a result, profits were substantially overstated. In 1998, AA agreed to pay $75 million to settle shareholder suits over its auditing of Waste Management.

Boston Chicken and Waste Management were not the only problems to arise at AA over this period. In 2001, AA agreed to pay $110 million to settle shareholder suits arising from its audits of Sunbeam Corporation. These suits also arose over AA's attestation of financial statements that were alleged to be overly positive.

Continued Changes as AA Moves into the Twenty-First Century

AC partners complained that AA's consulting with large companies violated their internal agreement to separate the two businesses—indeed, AC and AA competed for some of the same consulting engagements. In 1997, AC partners voted unanimously to split off entirely and filed a formal arbitration claim with the International Chamber of Commerce. Eventually AC was allowed to separate and form a new independent company, Accenture. AA partners suffered a significant financial setback when the arbitrator ruled that AA would not receive a $14 billion payment it had expected from AC upon separation.

In 1998, Samek became the managing partner at Arthur Andersen. Among his initial moves was to formulate a new strategy that included advice on how partners should *empathize* with clients. Samek surprised many of the auditing partners when he announced his new "2X" performance evaluation system. Partners were expected to bring in two times their revenues in work outside their area of practice. If an auditor brought the firm $2 million a year in auditing fees, he was expected to bring in an additional $4 million in fees from nonaudit services, such as tax advice and technology services. Partners who achieved this standard were rewarded, while others were penalized and in some cases dismissed from the company.

In addition to changing Andersen's organizational architecture, Samek tried to change the softer elements of the firm's corporate culture. For example, the dress code was relaxed, the wooden doors at Andersen's office entrances were removed, and the firm adopted a new corporate logo, the rising sun.

Soon Andersen partners began offering a new service to clients. Rather than just handling the once-a-year audit of the public books, the firm offered to take over the entire

internal bookkeeping function for their clients and provide internal audit services. Critics, such as Arthur Levitt (chairman of the SEC at the time), voiced concerns that this practice at least would impair the perceived quality of audits. Accounting firms engaged in this practice would essentially be checking their own work. In 2000, the SEC proposed new regulations that would limit the consulting work at accounting firms. In testimony before the Senate Banking Committee in July 2000, Samek called the SEC proposal "fatally flawed." He argued that the proposal was being made "just as we need to take an even more active role in making needed changes in the measurement and reporting system in support of better information for decision-making by corporations, investors, and government." Intense lobbying by the "Big Five" accounting firms defeated the SEC proposal.

Enron

Arthur Andersen began auditing Enron's books in 1986. By early 2001, Enron had grown into what was widely considered the "premier energy company" involved in wholesale energy trading and marketing, gas transmission, and electric utilities. Its market value of its equity in early 2001 was approximately $75 billion.

In the mid-1990s, Andersen hired Enron's entire team of 40 internal auditors. It added its own people and opened an office in Enron's Houston headquarters. With more than 150 people on site, Andersen staff attended Enron meetings and provided input into new businesses and other strategic issues. While the revenues from Enron represented a small fraction of Andersen's overall revenues, they were a large fraction of the Houston office's revenue and much of the livelihood of the firm's lead auditor in Houston, David Duncan.

In an attempt to speed up decision making and give local offices more power, Andersen's once-powerful Professional Standards Group was moved out of the Chicago headquarters and dispersed to local offices. Carl Bass was the PSG member at the Houston office. In 1999, he told Duncan that Enron should take a $30 million to $50 million accounting charge related to a specific transaction. Four months later, Andersen's management removed Bass from his oversight role at Enron in response to complaints by Enron's chief accounting officer, who wanted him off the audit. As one former staffer observed, "There were so many people in the Houston office with their fingers in the Enron pie. If they had somebody who said we can't sign this audit, that person would be fired."[3] This suggests that Andersen's auditors were aware of the accounting problems at Enron but chose to ignore them.

As 2001 drew to a close, Enron announced that it would take a $544 million after-tax charge against earnings related to its LJM2 Co–investment partnership. It also indicated that it would restate its financial statements for 1997–2001 because of accounting errors related to it partnerships. The company filed for bankruptcy on December 2, 2001—at that time the biggest bankruptcy filing in U.S. history. Numerous scandals relating to excessive compensation and perquisites for top executives, accounting fraud, and negligence on the part of Enron's board quickly followed. Enron's stock price fell from around $90 per share a year earlier to near zero by the end of 2001. Widespread concern among investors, regulators, and the public arose worldwide. Conflicts of interest apparently had motivated Andersen to sign off on what it knew were questionable accounting practices at Enron.

[3]"Accounting in Crisis," *BusinessWeek*, January 28, 2002.

The Demise of a Once Great Company

Arthur Andersen was subsequently charged with obstructing justice due to the shredding of documents and other evidence related to the case. Many outside observers concluded that Andersen staffers had shredded the documents to hide their own roles in producing fraudulent accounting statements. On January 24, 2002, Andersen issued the following press release:

> *While Andersen acknowledges the serious nature of actions and errors made by several of its Enron engagement employees, it also asks that all concerned be mindful that Andersen is 85,000 honorable, hardworking professionals worldwide—including 28,000 individuals and their families in the United States.*

Andersen placed most of the blame on David Duncan, who they claimed had violated the firm's ethical standards. Andersen quickly fired him.

Arthur Andersen ultimately was found guilty on a felony charge that it had obstructed the SEC's investigation of Enron when it shredded important documents and was prohibited from auditing publicly traded companies. The firm discontinued its auditing practice in August 2002. Andersen's reputation as an independent auditor was destroyed as the facts of its involvement with Enron's questionable accounting practices came to light. As early as January 2002, after Andersen announced it had shredded Enron documents, but before the Federal government issued criminal indictments for obstructing justice, Andersen clients began switching independent auditors. In fact, prior to August 2002, the date when Andersen was barred from auditing public companies because of its conviction for obstructing justice, 690 of its 2,300 public companies had already dropped Andersen as their independent public accountant. To many observers, Andersen's guilty verdict and eventual liquidation was a sad end for an organization that had once been the largest personal services firm in the world.

As a postscript, the United States Supreme Court in May 2005 unanimously overturned Andersen's guilty verdict in the Enron document shredding case and remanded the case back to a lower court for retrial.[4] Yet, by this time Andersen no longer existed as a public accounting firm; 28,000 Andersen employees lost their jobs when Andersen was indicted in June 2002. The federal government has not refiled the original obstruction of justice charges against Andersen.

Questions

1. Discuss the environmental, strategic, and organizational changes that occurred over the life of Andersen in the context of Figure 11.1.
2. Evaluate Andersen's claim that their problems on the Enron audit were due to a few "bad partners" in the organization. If you disagree with this claim, discuss what you think were the root causes of the problem.
3. Suppose you were Andersen's managing partner in the early 1990s. Would you have done anything differently than the actual management (assuming you knew only what they did at the time)? Explain.
4. Discuss the relation between what happened at Andersen and multitask principle agent theory.
5. Discuss the relation between the "hard" and "soft" elements of a firm's corporate culture in the context of this case.

[4]"Andersen Conviction Overturned," *Money.cnn.com*, May 31, 2005.

6. Do you think that the problems at Andersen were unique to them or did they exist at the other big accounting firms? Suppose you were the top partner at one of the other major accounting firms at that time of Andersen's demise. What actions, if any, would you take in response? Explain.
7. In 2000, the SEC proposed new regulations that would limit consulting work by accounting firms. This proposal was not passed by Congress. Do you think that the legislators were trying to act in the public interest when they failed to pass this proposal? Explain.
8. The American Institute of Certified Public Accountants is the primary professional association for certified public accountants. It has developed a *Code of Professional Conduct* that sets the standards of conduct for CPAs. People can file complaints about the ethical conduct of a CPA with the AICPA, which can levy sanctions and other penalties against its members. Do you think that the unethical conduct at Andersen (and possibly other accounting firms) was the fault of the AICPA for not setting and enforcing higher ethical standards among its members? Explain.
9. The Sarbanes-Oxley Act of 2002 established a new five-person board to oversee financial accounting in publicly traded corporations. The board is appointed by the Securities and Exchange Commission. Prior to the creation of this board the industry relied primarily on self-regulation through the American Institute of Certified Public Accountants. Do you think the establishment of the new oversight board was a good idea or should the profession have continued to be self-regulated?