

Don't Blame Joe Berardino For Arthur Andersen

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Much has been written about the demise of Arthur Andersen LLP (Arthur Andersen). On the surface, its unraveling began when it blessed Enron Corporation financial statements that overstated the energy trader's income and inflated its assets in the wake of some esoteric trading operations. Enron's shocking announcement of a \$600 million net loss and a \$1.2 billion shareholder equity writedown for the third quarter of 2001 prompted an SEC investigation of the company's accounting practices. Allegations of lax auditor oversight and document shredding emerged, followed by an indictment of the firm on charges of obstruction of justice. By the time Arthur Andersen was convicted in June 2002, a steady stream of client defections was well under way.

By September 2002, the denouement of this drama offered little suspense. After 89 years of attesting to the financial health of thousands of companies, Arthur Andersen would issue no more audit opinions. The firm had forfeited the most critical ingredient of any public accounting firm: the public trust. Without it, Arthur Andersen had no franchise.

How could a firm with such a sterling reputation fall so quickly? It is easy to point a finger at Joe Berardino, the former CEO of Arthur Andersen's parent company, Andersen Worldwide. Berardino vowed to quickly rebuild the firm after its messy split with Andersen Consulting gutted its standing as the world's largest professional services firm. As Business Week argued in a recent article, Berardino's myopic emphasis on revenue growth and then his clumsy handling of the Enron debacle make him the poster child of failed corporate leadership.

Berardino as the poster child of a fallen icon? Certainly. The leader responsible for its implosion? Hardly. In reality, Arthur Andersen's decline cannot be traced to a single leader or a single event in the firm's history. Its fall was a steady but accelerating erosion of its founding principles. Eventually, the firm's underpinnings deteriorated to the point where the firm became highly unstable and unbalanced, its very size and ambition a threat to itself.

How does a firm that grew so rapidly to become the world's largest professional services firm and an icon of professionalism be in decline at the same time? Except to a handful of Arthur Andersen audit practice veterans and perhaps some longtime attorneys at the SEC, Arthur Andersen's decline was largely invisible. Despite the well-publicized struggles between audit partners and consulting partners in the 1990's, the firm appeared to be thriving. In reality, it was deteriorating from its core.

What Ozymandias Did Not Know

In 1994, Stanford professors Jerry Porras and Jim Collins published *Built to Last*, which attempted to unveil the secrets of great, enduring companies. The principal findings from their research on hundreds of companies were that the world's best-performing, long-lived companies lived by a set of rock solid principles collectively known as Vision. Vision, according to the book, is a set of company-specific beliefs that guide their holders through market evolution, economic cycles, technology change, leadership transition, and other forces of upheaval that often sink non-visionary firms.

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A JOURNAL OF STRATEGY & BUSINESS TRANSFORMATION

One of the keys to living a Vision is having a clear understanding of what is vitally core to the organization while also mastering the mechanisms that stimulate continuous forward progress. Visionary companies do both. They preserve their core ideology by adhering to a handful of self-professed principles that require no external justification or even tangible evidence of their benefits. At the same time, they rely on embedded mechanisms to generate continual forward movement—mechanisms that enable experimentation, learning, and change.

Built To Last argues that these principles can steer companies through good times and bad. If a company is a sailing ship, its core ideology becomes its map and compass, assuring captain and crew that certain routes offer favorable winds, predictable currents, and safe seas, while others offer unknown perils that should never be tempted. For example, 3M has always adhered to its belief in innovation and solving problems, regardless of economic standing or business strategy. Its unwavering belief in these core values (along with several others), has given it a strong sense of stability even during turbulent times throughout its lengthy history. In short, in an ever-changing and sometimes turbulent world, a company's core ideology endows it with a sense of proven and reliable beliefs that can guide it in the absence of clear direction.

For decades, Arthur Andersen lived by a powerful ideology centered around its core value of independence—a fundamental and unwavering belief in rendering opinions that upheld the standards of the profession irrespective of powerful forces that favored expediency for its clients. The firm's allegiance to this principle enabled it to resist clients seeking lenient treatment of their accounting practices. It also compelled Arthur Andersen to become the industry's leading critic of lax oversight, as well as its most dogmatic advocate of new standards designed to serve shareholders to the fullest. It was a powerful guiding principle that served the firm through generations of leaders, partners, technologies, competitors, and clients.

Yet somehow, Arthur Andersen strayed from and eventually abandoned this belief.

Answering To a Higher Authority

Core Values are not convenient slogans that can be invoked to rally employee morale or impress clients. Firms that have core values live by them, and often pay a significant price for doing so. Within a year of opening his accounting firm, Arthur Andersen himself refused to certify the skewed accounts of a large railroad client. Despite the insistence and eventual threats of the railroad president, Mr. Andersen simply replied that no amount of money could make him approve bad bookkeeping. Arthur Andersen lost the client, but laid a piece of foundation that would serve the firm for decades to come.

This is the first evidence of Arthur Andersen's core value of independence. The firm endowed itself with the courage to say "no" to clients, even at the risk of losing their business, because Arthur Andersen felt that its true customers were shareholders. Typical of core values, Mr. Andersen's insistence on rigorously applying the standards of public accounting embedded itself in the fabric of his firm. Its lore sent an unmistakable message to college graduates hired into the firm. Mr. Andersen urged his staff to "think straight, talk straight", suggesting that the firm's business left little room for interpreting the books beyond what was specified by the rules of the profession.

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It is not unusual that Arthur Andersen inherited its founder's steadfast belief in rendering audit opinions irrespective of clients' sometimes-pointed interests. Many start-up firms adopt the personal values of their founders. What transforms a founder's belief into a core value is, among other things, its ability to transcend generations of leadership. Arthur Andersen probably had an even more dogmatic believer in independence in its second leader, Leonard Spacek.

Spacek was even more outspoken against the audit industry's chummy client relationships than his predecessor. He was purportedly even more blunt with clients, at one point informing a client that Price Waterhouse would be a better choice than his own firm for a specific piece of accounting expertise. In a famous speech to railroad industry controllers in 1957, Spacek railed against the industry's self-serving accounting standards so daringly that some of his peers outside the firm tried to revoke his accounting license for defaming the profession. They failed.

For Arthur Andersen, living its core value of independence went well beyond the act of its top leaders carrying its brazen message to clients and industry counterparts. The firm's Professional Standards Group was endowed with the final say on any and all of the complex accounting issues facing its army of auditors. It was no coincidence that this group was comprised of the firm's most technically astute partners—and not its rain-makers.

This group's sense of purpose enabled Arthur Andersen to continue to lead the industry in establishing conservative standards on controversial issues, often to the chagrin of its competitors. In the late 1970's, the firm virtually single-handedly ordered that the immensely successful IBM 360 computer be amortized over five years, instead of the then-accepted ten years. Arthur Andersen also pushed for a revised bank loan accounting standard that many predicted would anger the firm's clients. The rule was eventually adopted, and the clients stuck around.

Arthur Andersen found that rigorous auditing paid off. The firm grew rapidly. By 1970, the firm had offices in 27 countries employing more than 10,000 people and generating enough revenue to make it the second largest audit firm behind Peat Marwick. Rapid growth posed new problems, and the firm worked vigorously to establish and maintain standards for audit quality and consistency across its expanding empire. During this period, the firm developed the slogan "One Firm, One Mind" to signify its dedication to professionalism and adherence to its standards. Like many visionary firms that expend considerable energy and resources to preserve their core, Arthur Andersen recruited young, trained heavily, and fostered a culture that bred a sense of upholding a higher responsibility to the investing public.

Cracks in the Foundation

It was also during the 1970's that the firm introduced its double wooden doors as a symbol of confidentiality—and separation—from its clients and industry peers. Perhaps the thick double doors were also an indication of the difficult challenges to come. Recession brought on stiff price competition and stalling audit revenues. Lawsuits by disgruntled shareholders over the business failures of some high-risk clients instigated a legal battle with the SEC that some claim created an adversarial relationship that lasted for decades.

These events were the first visible tremors of forces that would continually shake the firm over the next

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thirty years. The opposing forces of a stagnating audit business and a rapidly growing consulting business created a "stress" fracture along these practice lines. This was not the case of an upstart group of partners splintering off in a new direction in an opportunistic bid to recharge revenue growth. Rather, it was the inexorable and accelerating build-up of two forces moving in opposite directions. Arthur Andersen's consulting roots extended back to 1942, when it launched its Administrative Accounting division. In 1954, the firm installed arguably the first-ever computerized accounting system in a project for General Electric. By 1968, consulting fees totaled 23% of firm revenues. By 1979, that figure had reached 42%.

Still, Arthur Andersen continued to be guided by its belief in independence above all else. In 1979, the SEC, increasingly concerned about potential conflicts of interest posed by audit firms performing non-audit services, suggested that clients disclose the amount and percentage of non-audit fees paid to its auditors. Not to be outdone, Arthur Andersen's leadership proposed an even more radical step: completely separate audit and non-audit practices. Harvey Kapnick, the firm's third leader, was well aware of the ethical stresses within the partnership created by the consulting practice. He proposed a spin-off of the consulting business into a sister firm.

Kapnick was confident that his proposal would be accepted by the partnership at the firm's annual meeting. Instead, it caused uproar. The audit partners loudly refused to let go of the golden consulting goose. Kapnick resigned in disgust. The fault line was now plainly visible.

It would be dangerous to cite this event as the point in Arthur Andersen's history when its trajectory changed from being a champion of shareholders' rights to veering toward an ethical wilderness. It was, however, an opportunity for the firm to look into the mirror and perhaps recognize the forces that were challenging its fundamental beliefs. As it was, the unresolved question about mixing audit and consulting services with clients was allowed to fester.

And fester it did. In 1984, Arthur Andersen's consulting business generated more profit than its auditing business for the first time in the firm's history. In 1989, Arthur Andersen formally separated its audit and consulting practices by creating two firms under an umbrella firm. By this time, it was clear that the firm was no longer of "one firm, one mind." The firm had lost its center of gravity, and was now unbound and free to fall in any direction.

By the 1990's, the direction was clear. Partners in both the audit and consulting practices witnessed the strained marriage erupt into a bitter power struggle at the top. It then began to spiral toward divorce. Both sides began devoting increasing time and energy to preparing for life after the final break-up. To say that these events were a distraction would probably be an understatement.

In the meantime, the Professional Standards Group, once the map and compass for pinpointing the firm's direction on sensitive accounting issues, saw its authority vanish. In 1992, the firm's top managers instructed the Accounting Principles Group to rethink its conservative position on expensing stock options. Ten years before, the mere act of challenging this group would have been unthinkable. Now, its opinions barely seemed to matter. Perhaps the final insult to the group was the removal of Professional Standards Group partner Carl Bass from the Enron account at the client's request, after Bass had raised serious concerns about some of Enron's policies.

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A Signpost on the Road Behind

Clearly, Arthur Andersen's implosion is much more than a tale of a firm paying a heavy price for dereliction of duty. Could anything have been done to prevent its implosion? Perhaps. There was 1979 and the caustic reaction among the partners to the notion of spinning off the consulting business. This question could have been an opportunity for the firm to re-examine its ideological roots and perhaps recognize the strain that it was under. It might have found a solution to maintain its core beliefs while serving clients in new and responsible ways.

It could have walked away from Enron and other high-risk clients. The firm had actually done this in the 1980's after some painful outcomes from shareholder lawsuits over audits of failed clients. Arthur Andersen introduced a process to rank clients according to their risk of bankruptcy, and began severing ties with clients likely to fail. Among these were Lincoln Savings & Loan, which at the time was a substantial source of revenue for its Phoenix office. The high profile thrift collapsed three years later.

Ironically, the Phoenix audit practice was cited sixteen years later in the collapse of another organization that became entangled in speculative real estate investments: the Baptist Foundation of Arizona. This instance suggests that by the late 1990's, it was too late for Arthur Andersen to rediscover the internal fortitude to shed risky clients. Much of the discretionary power over client relationships that had once been at the structural and intellectual center of the firm had been devolved to partners in local offices. The rainmakers now made policy. The firm's center had been lost.

Another potential opportunity passed in 2000. An arbitrator finally ruled that Andersen Consulting could buy its way out of the partnership for \$1 billion and its agreement to leave the Andersen name behind. The separation ruling gave Arthur Andersen a ready-made excuse for reinventing itself. Its reputation, though sullied somewhat by high-profile audit problems with Waste Management and Sunbeam, was intact, and the ten-year long distraction of the separation battle was nearing an end. However, with the firm's breakup looming in the mid-1990's, the audit partners had already committed the firm to resuming its pursuit of fast-growing non-audit business once the divorce was finalized. Arthur Andersen's leaders gave little thought to the possible alternatives in creating the "new" Arthur Andersen.

There were likely many instances over the past twenty years where Arthur Andersen could have viewed itself as standing at a crossroads. Had the firm paused from its dealings with an industry and an organization culture that was undergoing wrenching change, it might have noticed its gradual but inexorable drift away from its center. It might have seen a signpost: one arrow pointing back to its roots as a defender of the public trust, the other toward an unknown future. In reality, the firm breezed through the intersection with hardly a glance out the window.

The author thanks Richard Wardell for his contributions to this article.

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