2.3 WorldCom: Professional Responsibility

Synopsis On June 25, 2002, WorldCom announced that it would be restating its financial statements for 2001 and the first quarter of 2002. Less than one month later, on July 21, 2002, WorldCom announced that it had filed for bankruptcy. It was later alleged that WorldCom had engaged in improper accounting that took two major forms: overstatement of revenue by at least $958 million and understatement of line costs, its largest category of expens- es, by over $7 billion. Several executives pled guilty to charges of fraud and were sentenced to prison terms, including CFO Scott Sullivan (five years) and Controller David Myers (one year and one day). Convicted of fraud in 2005, CEO Bernie Ebbers was the first to receive his prison sentence: 25 years. Andersen’s Relationship with WorldCom Andersen served as WorldCom’s auditor from at least as far back as 1990 through April 2002. In a presentation to the audit committee on May 20, 1999, Andersen stated that the firm viewed its relationship with WorldCom as a “long-term partnership,” in which Andersen would help WorldCom improve its business operations and grow in the future. In its Year 2000 audit proposal, Andersen told the audit committee that it considered itself “a committed mem- ber of [WorldCom’s] team” and that WorldCom was “a flagship client and a ‘crown jewel’” of its firm.1 In terms of the total fees charged to clients, WorldCom was one of Andersen’s top 20 engagements in 2000 and was the largest client of its Jackson, Mississippi, office. From 1999 through 2001 WorldCom paid Andersen $7.8 million in feesaudits required by law in other countries; and about $50 million for consulting, litigation support, and tax services.2 Andersen’s Restricted Access to Information WorldCom allegedly severely restricted Andersen’s access to information; several of Andersen’s requests for detailed information and opportunities to speak with certain employees were denied. In fact, Andersen was denied access to WorldCom’s computerized general ledger and had to rely on the printed ledgers. According to the person in charge of security for WorldCom’s comput- erized consolidation and financial reporting system, WorldCom’s treasurer in 1998 instructed him not to give Andersen access to this computerized reporting system.3 In addition, senior management of WorldCom allegedly berated employees who disclosed unauthorized information to Andersen. For example, in October 2000 Steven Brabbs, the director of international finance and control for EMEA (Europe, Middle East, and Africa), told Andersen’s U.K. office that line cost ex- penses for EMEA were understated by $33.6 million because senior management had reduced its line cost accruals and that EMEA did not have any support for this entry. WorldCom’s senior vice president and controller David Myers reprimanded Brabbs and directed him never to do it again. In early 2002, after learning about an- other conversation between Brabbs and Andersen about a planned restructuring charge, Myers specifically instructed U.K. employees that “NO communication with auditors is allowed without speaking with Stephanie Scott [vice president of financial reporting] and myself. This goes for anything that might imply a change in accounting, charges, or anything else that you would think is important.” When Myers found out that the accountant had continued to speak with Andersen U.K. about the issue, he wrote the following message to the accountant:4 Do not have any more meetings with Andersen for any reason. I spoke to Andersen this morning and hear that you are still talking about asset impairments and facilities. I do not want to hear an excuse just stop. Mark Wilson has already told you this once. Don’t make me ask you again. Although Andersen was aware that it was receiving less than full coopera- tion, it did not notify WorldCom’s audit committee about this matter.5 Indeed, the special investigative committee of the board of directors at WorldCom (the special committee) found no evidence that its independent auditor, Arthur Andersen, had determined that WorldCom’s revenues or line costs were im- properly reported. However, it did find that Andersen’s failure to detect these improprieties likely stemmed, in part, from a failure to demand supportingtunities that might have resulted in the detection of these improprieties.6 Audit Approach Apparently the auditors from Arthur Andersen understood the elevated risk associated with the WorldCom audit. Based on a review of the workpapers by the special investigative committee, it was discovered that Andersen rated WorldCom a “maximum risk” client. Because of the maximum risk classifica- tion, Andersen’s internal policies required the engagement team to consult with Andersen’s practice director, advisory partner, audit division head, and professional standards group (where appropriate) regarding all significant audit issues. In addition, the lead engagement partner was required to hold an annual expanded risk discussion with the concurring partner, the practice director, and the audit division head to consider the areas that caused greatest audit risk. Surprisingly Andersen did not disclose that WorldCom was con- sidered a maximum risk client to the audit committee of WorldCom.7 The outcome of the expanded risk discussion after the 1999 and 2000 year-end audits was that Andersen did not find evidence of aggressive accounting or fraud at WorldCom.8 However, during the discussion held in December 2001, concerns were voiced over WorldCom’s use of numerous “top-side” journal entries. Such entries are typically recorded at the corporate level, detached from the economic activity that is occurring at each of the business units or divisions within World- Com. A handwritten note in Andersen’s workpapers read, “Manual Journal En- tries How deep are we going? Surprise w[ith] look [at] journal entries.” Yet there was no indication of further testing on these entries.9 In all, the special investiga- tive committee found hundreds of large, round-dollar journal entries that were made by WorldCom’s general accounting group staff without any support other than Post-it® Notes or written instructions directing that the entries be made. The special committee found that Andersen relied heavily on substantive analytical procedures and conducted only a limited amount of substantive tests of details. In addition, the element of surprise was lost because Andersen often provided WorldCom’s senior management team with a list of the auditing procedures that it anticipated performing in the areas of revenues, line costs, accounts receivable, capital expenditures, and data integrity. Furthermore, Andersen’s testing of capital expenditures, line costs, and revenues did not change materially from 1999 through 2001.101. Consult PCAOB Ethics and Independence Rule 3520. What is auditor independence, and what is its significance to the audit profession? Based on the case information, do you believe that Andersen violated this rule? Why or why not? 2. Consult Paragraphs 5–7 of PCAOB Auditing Standard No. 13. Given the reluctance of WorldCom’s management team to communicate with Andersen, do you believe that Andersen exercised due care and professional skepticism in completing the audit? Why or why not? 3. Consult Paragraphs 13–21 of PCAOB Auditing Standard No. 15. In terms of audit effectiveness and efficiency, briefly explain the difference between substantive analytical procedures and substantive tests of details. Do you believe it was appropriate for Andersen to rely primarily on substantive ana- lytical procedures? Why or why not? 4. Consult Paragraphs 14 and A8 (in Appendix A) of PCAOB Auditing Standard No. 5. Provide an example of both a preventive control and a detective control that could address the risk that a fraudulent top-side adjusting journal entry could be made by a member of management.