Case 1.4

WorldCom: A Focus on 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. On July 21, 2002, WorldCom announced it had filed for bankruptcy. It was later revealed that WorldCom had engaged in improper accounting that took two major forms: the overstatement of revenue by at least $958 million and the understatement of line costs, its largest category of expenses, by over $7 billion. With Bernie Ebbers setting the tone of "hitting" the numbers at all costs, senior members of the corporate finance organization, led by CFO Scott Sullivan, directed the improper accounting.

Andersen's Relationship with WorldCom

The Special Investigative Committee of the Board of Directors (the Special Committee) found no evidence that WorldCom's independent auditor, Arthur Andersen, in fact determined that WorldCom's revenues or line costs were improperly reported. However, it did find that Andersen's failure to detect these improprieties likely stemmed, in part, from a failure to demand supporting evidence for certain recorded transactions and some other missed audit opportunities that might have resulted in the detection of these improprieties.[45]

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

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[45] Board of Directors' Special Investigative Committee Report, June 9, 2003, 25. The committee qualified its analysis as follows: "We had access to only a portion of Andersen's documents, and Andersen personnel refused to speak with us. Therefore, we cannot answer with certainty the question why Andersen failed to detect such a large fraud."

member of [WorldCom's] team" and that WorldCom was "a flagship client and a 'crown jewel'" of its firm.[46]

In terms of the total amount of fees charged to clients, WorldCom was one of Andersen's top 20 engagements in 2000, and the largest client of its Jackson, Mississippi, office. From 1999 through 2001, WorldCom paid Andersen $7.8 million in fees to audit the financial statements of WorldCom, Inc.; $6.6 million for other audits required by law in other countries; and about $50 million for consulting, litigation support, and tax services.[47]

Andersen's Restricted Access to Information

WorldCom 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 computerized consolidation and financial reporting system, WorldCom's treasurer in 1998 instructed him not to give Andersen access to this computerized reporting system.[48]

In addition, senior management of WorldCom 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 expenses for EMEA were understated by $33.6 million because senior management had reduced their 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 another 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:[49]

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[46] Board of Directors' Special Investigative Committee Report, June 9, 2003, 225.

[47] Board of Directors' Special Investigative Committee Report, June 9, 2003, 225.

[48] Board of Directors' Special Investigative Committee Report, June 9, 2003, 246–248.

[49] Board of Directors' Special Investigative Committee Report, June 9, 2003, 250–251.

> 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 cooperation, it did not notify WorldCom's Audit Committee of this matter.[50]

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 of the Board of Directors, it was discovered that Andersen rated WorldCom a "maximum risk" client. Because of the maximum risk classification, 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 Expanded Risk Discussion on an annual basis 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 to the public that WorldCom was considered a maximum risk client to the Audit Committee of WorldCom.[51]

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.[52] However, during the discussion that was 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 WorldCom. A handwritten note in Andersen's workpapers read: "Manual Journal Entries How deep are we going? Surprise w[ith] look [at] journal entries." Yet, there was no indication of further testing on these entries.[53] In all, the Special Investigative Committee found hundreds of large, round-dollar journal

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[50] Board of Directors' Special Investigative Committee Report, June 9, 2003, 25–26.

[51] Board of Directors' Special Investigative Committee Report, June 9, 2003, 27.

[52] Board of Directors' Special Investigative Committee Report, June 9, 2003, 232–233.

[53] Board of Directors' Special Investigative Committee Report, June 9, 2003, 236.

entries that were made by WorldCom's General Accounting group staff, without any support other than a Post-it® Note or written instructions directing the entry to 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 as 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.[54]

Case Questions

1. Please consult Paragraph #32 of PCAOB Auditing Standard No. 2. Based on the case information, do you believe that Andersen violated any of the four basic principles of auditor independence described? Why or why not?
2. Consult Paragraphs #35–36 of PCAOB Auditing Standard No. 2. Given the reluctance of WorldCom's management team to communicate with Andersen, do you believe that Andersen exercised "Due Professional Care" and "Professional Skepticism" in completing the audit? Why or why not?
3. In terms of audit effectiveness and efficiency, briefly explain the difference between substantive analytical procedures and substantive test of details. Do you believe it was appropriate for Andersen to rely primarily on substantive analytical procedures? Why or why not?
4. Consult Paragraph #154 of PCAOB Auditing Standard No. 2. Provide an example of both a substantive analytical procedure and a test of detail that could be used to gather evidence about a "top-side" adjusting journal entry.

[54] Board of Directors' Special Investigative Committee Report, June 9, 2003, 228.