Case 3.7

WorldCom: A Focus on Internal Audit

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.

Internal Audit Department

The Audit Committee of the Board of Directors at WorldCom had ultimate responsibility for ensuring that the company's systems of internal controls were effective. The internal audit department periodically gathered information relating to aspects of the company's operational and financial controls and reported its findings and recommendations directly to the Audit Committee. Dick Thornburgh, WorldCom's bankruptcy court examiner, wrote in his Second Interim Report released on June 9, 2003, that "the members of the Audit Committee and the internal audit department personnel appear to have taken their jobs seriously and worked to fulfill their responsibilities within certain limits."[175]

However, the bankruptcy examiner also wrote that it found a number of deficiencies in both the internal audit department and the Audit Committee. Among the factors that led to deficiencies being noted in the internal audit department included its relationship with management, lack of budgetary resources, lack of substantive interaction with the external auditors, and its restricted access to relevant information.[176]

WorldCom's internal audit department focused its audits primarily on the areas that were expected to yield cost

[175] Second Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, June 9, 2003, 12.

[176] Ibid., 174–176.

savings or result in additional revenues.[177] In planning its audits, the department did not conduct any quantifiable risk assessment of the weaknesses or strengths of the company's internal control system. In addition, the department's lack of consultation with WorldCom's external auditor, Arthur Andersen, resulted in even further audit coverage gaps.[178]

The SEC's investigation revealed that management's influence over the activities of the internal audit department may have superseded those of the Audit Committee. It appeared that management was able to direct the internal audit department to work on audits not previously approved by the Audit Committee and away from other audits that were originally scheduled. At most, the Audit Committee was advised of such changes, after the fact.[179]

Internal Audit Department's Relationship with Management

Although the Audit Committee annually approved the audit plans of the internal audit department, it seemed to have had little input into the development of the scope of each audit or the disposition of any findings and/or recommendations. The Audit Committee also did not seem to play any role in determining the day-to-day activities of the internal audit department. Rather, the CFO appeared to provide direction over the development of the scope of the department's audit plans, the conduct of its audits, and the issuance of its conclusions and recommendations. The CFO also oversaw all personnel actions for the department, such as promotions and increases in salaries, bonuses, and stock options granted.[180]

The internal audit department distributed preliminary drafts of its internal audit reports to the CFO, Scott Sullivan and, at times, the CEO Bernie Ebbers. The internal audit department also distributed preliminary drafts of its reports to the management that was affected by a particular report. All persons on the distribution list provided their input on the conclusions and recommendations made in the reports. In contrast, the Audit Committee did not receive any preliminary drafts of the internal audit reports.[181]

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[177] Ibid., 186–187.

[178] Ibid., 194–195.

[179] Ibid., 194–195.

[180] Ibid., 190–191.

[181] Ibid., 195–197.

It was also found that, CFO Sullivan or CEO Ebbers had assigned certain special projects to the internal audit department. Some of these projects were not audit-related, and the Audit Committee did not appear to have been consulted about such assignments.[182]

Impact of Lack of Budgetary Resources

According to the 2002 Global Auditing Information Network (GAIN) peer study conducted by The Institute of Internal Auditors, WorldCom's internal audit department (at a staff of 27 by 2002) was half the size of the internal audit departments of peer telecommunications companies. The head of the internal audit department, Cynthia Cooper (a vice president), presented the results of the GAIN Study to the Audit Committee in May 2002. She advised them that her department was understaffed as well as underpaid. The minutes reflect that she advised the committee that the average cost of each of their internal auditors was $87,000 annually, well below the peer group average of $161,000.[183]

The budgetary resources allocated to the department seemed particularly inadequate given the international breadth and scope of the company's operations and the challenges posed by the company's various mergers and acquisitions over a relatively short period of time. For example, budget constraints restricted travel by internal audit staffers outside of Mississippi, where most of the internal audit staff was located. Such a restriction made managing and conducting audits of company units located outside of Mississippi, and, particularly, international audits far more difficult.[184]

Lack of Substantive Interaction with External Auditors

Arthur Andersen's annual statement to the Audit Committee noted no serious internal control weaknesses found as part of its annual audit of the company's financial statements. Yet, in the same year, the internal audit department had identified a number of seemingly important internal control weaknesses as part of its operational audits that impacted financial systems and the reporting of revenue. It appears no communication occurred between the internal and the external auditors to ensure awareness about all of the internal control weaknesses that were discovered. In

[182] Ibid., 190–191.

[183] Ibid., 192–193.

[184] Ibid., 192–193.

fact, after 1997, internal audit had few substantive interactions with the company's external auditors other than at the quarterly meetings of the Audit Committee, where both groups made presentations.[185]

Restricted Access to Information

Support of the internal audit department was not universal throughout the company. There were allegedly many instances when management refused to answer or dodged certain questions asked by internal audit personnel. In several cases, internal audit personnel had to make repeated requests for information, and their requests were not always furnished in a timely manner.[186]

In addition, the internal audit department had limited access to the company's computerized accounting systems. Although the internal audit charter provided that internal audit had "full, free, and unrestricted access to all company functions, records, property, and personnel," few internal audit staff personnel had full systems access to the company's reporting system, and the company's general ledgers.[187]

Case Questions

1. Consult Paragraph #24 of PCAOB Auditing Standard No. 2. Based on your understanding of WorldCom's internal audit department, do you believe that the department was an "adequate" control to help prevent or detect fraud at WorldCom? Why or why not?
2. Please consult Paragraphs #55–59 of PCAOB Auditing Standard No. 2. Based on the case information, do you believe that WorldCom's audit committee was effective in its management of the internal audit department? Why or why not?
3. Please consult Paragraphs #40–41 of PCAOB Auditing Standard No. 2. How would an auditor's requirement to evaluate management's process have changed the nature and type of communication between the internal audit department and the external auditors at WorldCom?
4. Consult Paragraph #108 and Paragraphs 117–120 of PCAOB Auditing Standard No. 2. Can external auditors use the work already completed by internal auditors as evidence to support their own opinion? If so, what are the

[185] Ibid., 193–194.

[186] Ibid., 195–197.

[187] Ibid., 195–197.

factors that the external auditor must consider before using the work of internal auditors?

5. Please consult Q54 of the PCAOB Staff Questions & Answers (May 16, 2005). Please define what is meant by the "principal evidence" requirement. Please explain the nature of the evaluation (e.g., is it qualitative or quantitative?).