Auditing after Sarbanes-Oxley

Illustrative Cases

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Jay C. Thibodeau

Deborah Freier

McGraw-Hill

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AUDITING AFTER SARBANES-OXLEY: ILLUSTRATIVE CASES

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This book is dedicated to Ellen, my extraordinary wife of 15 years, and my children, Jenny, Eric, and Jessica. You have all provided the inspiration for me to undertake and complete this project. I could not have accomplished it without your love. Thank you.

Jay C. Thibodeau
I dedicate this book in loving memory of my father, Martin Freier, who inspired me to work hard and to strive for excellence. He also inspired me and others with his strength, his integrity, his dedication to family and friends, his desire to help others, his deep abiding love for learning, his wide array of talents and interests, and his appreciation for life. He was a great man and will truly be missed.

This book is also dedicated to Matt, who always believed in me and was a constant source of support.

Deborah Freier

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Dr. Thibodeau is the Edward F. Gibbons Research Professor at Bentley College. He received his B.S. degree from the University of Connecticut in December 1987 and his Ph.D. from the University of Connecticut in August 1996. He joined the faculty at Bentley College in September of 1996 and has worked there ever since. During his sabbatical in the Fall Semester of 2003, Jay worked with PricewaterhouseCoopers’ Learning & Education group to help deliver critical knowledge about the post-Sarbanes-Oxley technical audit guidance to professionals throughout the firm. He has consulted with PricewaterhouseCoopers ever since. At Bentley College, he serves as the coordinator for all audit and assurance curriculum matters.

Dr. Thibodeau currently serves as the Chair of the National Education Committee for the American Accounting Association’s Auditing Section. He has been published in Auditing: A Journal of Practice & Theory, Issues in Accounting Education, Commercial Lending Review, Advances in Accounting Education, Asian-Pacific Journal of Accounting, Practical Accountant, and Journal of Financial Education and Managerial Auditing. He has received national recognition for his work three times: first, for his doctoral dissertation, winning the 1996 Outstanding Doctoral Dissertation Award presented by the American Accounting Association’s ABO Section; second, for curriculum innovation, winning the 2001 Joint AICPA/AAA Collaboration Award; and third, also for curricular innovation, winning the 2003 Innovation in Assurance Education Award.
Deborah Freier

Deborah Freier graduated as the valedictorian of her class at Bentley College. Ms. Freier was also honored by the Financial Executives Institute as the Outstanding Graduating Student and received the Wall Street Journal Student Achievement Award. Ms. Freier placed in the semi-finals of the Institute for Management Accountants 2000 National Student Case Competition. She was also inducted into Beta Gamma Sigma, Beta Alpha Psi, Omicron Delta Epsilon, and the Falcon Society. In addition, she was the co-chair of Beta Alpha Psi’s student leadership conference her senior year and was a member of the winning teams in the Bentley College Strategy Case and Business Bowl competitions.

Ms. Freier worked several years as a research associate in the Strategy Department at Harvard Business School. She collaborated with professors to create content for cases, presentations, and articles that explored issues related to competitive advantage, intellectual property strategies, network effects and standards wars, and expansion into new geographic and strategic markets. She also developed teaching materials for an elective course about game theory and its application to business strategy. During her time at Harvard Business School, Ms. Freier co-authored more than 15 cases.

Ms. Freier is currently working as a senior analyst in the Strategy and Product Development Department at Tufts Health Plan, where she plays a key role in developing financial and competitive analyses for senior management.

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Preface

After a multitude of high profile business failures and accounting restatements (Enron, WorldCom, and Qwest, to
name a few) in 2001 and early 2002, Congress responded to the eroding investor confidence in audited financial statements by passing the Sarbanes-Oxley Act of 2002 (SOX). This law has required auditors to increase their audit work on internal controls systems and has forced audit firms to revamp their audit processes for publicly traded companies. The changes have been far-reaching and dramatic for both audit firms and their clients.

In the face of these sweeping regulatory changes, as well as other changes in the profession, auditing education needs to rise to the challenge of preparing audit professionals. Auditing after Sarbanes-Oxley presents instructors with 35 cases focusing on specific audit issues that were directly impacted by Sarbanes-Oxley, using the actual companies—Enron, WorldCom, Qwest—that have become synonymous with the capital markets’ crisis in confidence. Importantly, the cases provide in-depth, up-to-date coverage of the post-Sarbanes technical audit guidance issued by the PCAOB.

Our approach to this book emphasizes the substantial benefits of using real life case examples in helping to impart knowledge related to the practice of auditing. In the education psychology literature, this type of approach has long been acknowledged as a superior manner in which to impart knowledge. In addition, there is evidence from other disciplines that the use of cases as a mechanism to impart a range of critical auditing skills, including technical skills, interpersonal relations, and ethical analysis, will be quite effective. So, by presenting the concepts of auditing using actual corporate contexts, we seek to provide readers with a real-life appreciation of these issues and clearly demonstrate the value of the Sarbanes-Oxley Act of 2002 and other changes that have been mandated by the PCAOB.

We set out to design a casebook that could be easily adopted by instructors in their classes. The cases run only three to five pages in length, which dramatically reduces the time necessary for students to grasp key learning objectives. In addition, each case focuses on a specific topic to help ensure student mastery of that topic. Our approach can be contrasted with many traditional audit cases that range from 10 to 20 pages in length and introduce multiple learning objectives concurrently.

In addition, our book has been designed to reflect an organization that closely mirrors the leading auditing and assurance textbooks. We have grouped our cases into the following categories: Ethics and Professional Responsibility; Understanding the Client’s Business and Industry; Internal Control Systems; and Audits of Accounts, Processes, and Assertions. In looking over the table of contents for this book, you will note that each category has multiple cases that can be used in the classroom. This was done for two reasons. First, it allows instructors the
opportunity to illustrate the critically important auditing concepts with multiple real-life contexts, if they so choose. And second, it affords instructors with an opportunity to assign the cases on a rotating basis, if they so choose. Consider that with 35 different cases, instructors can assign 8 to 9 different cases for each of four different semesters. This will reduce the possibility of case solutions circulating around campus. Also, we have provided complete company cases to give instructors the option of presenting longer cases that focus on several issues related to a particular company.

Finally, and perhaps most important, each of our cases will contribute to students’ understanding of the changes brought about by the Sarbanes-Oxley Act of 2002, a significant objective in any current undergraduate or graduate auditing course. For example, in its Auditing Standard No. 2, “An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements,” the PCAOB has made clear that evaluating and documenting the relationship between the internal control activities and the financial statement assertions (PCAOB 2004, Paragraph #84) is instrumental in completing the audit, underscoring the importance of understanding the linkage between internal control activities, internal control objectives, and financial statement assertions. Thus, one important and explicit objective of this book is to help impart knowledge about these linkages through the use of real-life case examples.

**Technical Audit Guidance**

To maximize a student’s knowledge acquisition of this material, this book has been designed to be read in conjunction with the post-Sarbanes-Oxley technical audit guidance. All of the post-Sarbanes-Oxley technical guidance is available for free at http://www.pcaobus.org/Standards/index.aspx. In addition, a summary of the Sarbanes-Oxley Act of 2002 is also available for free at http://www.aicpa.org/info/sarbanes_oxley_summary.htm.

**Acknowledgments**

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Finally, we want to express our sincere gratitude to James Bierstaker (Villanova University) and Christine Earley (Bentley College) for their willingness to class-test several of the cases. In addition, we express our gratitude to the following reviewers for their contribution to this first edition: Faye Borthick, Georgia State University; Kimberly Burke, Millsaps College; Jeff Cohen, Boston College; Mary Curtis, University of North Texas; Parveen Gupta, Lehigh University; Janet Jamieson, University of Dubuque; Marshall Pitman, University of Texas–San Antonio; John Rigsby, Mississippi State University; Kathleen Simons, Bryant University; Bernice Sutton, Florida Southern College; Susan Toohey, Lehigh University; Pervaiz Alam, Kent State University; Cynthia Daily, University of Arkansas–Little Rock; Anita Feller, University of Illinois at Urbana Champaign, as well as other anonymous reviewers.
Section 1

Ethics and Professional Responsibility

While the Sarbanes-Oxley Act of 2002 (SOX) has had a dramatic impact on all stakeholders in the financial reporting process, arguably the most dramatic change has been that the auditing profession is now regulated. The Public Company Accounting Oversight Board (PCAOB) is now responsible for setting all auditing standards pertaining to audits of publicly traded companies. The PCAOB is also required to perform detailed inspections of audit work completed and quality control processes employed by audit firms. These changes are sure to have a dramatic impact on the auditing profession. The following cases are designed to illustrate the ethical and professional responsibility of auditors in the post-Sarbanes auditing environment.

The case readings have been developed solely as a basis for class discussion. The case readings are not intended to serve as a source of primary data or as an illustration of effective or ineffective auditing.

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Case 1.1

Enron: A Focus on Independence and Ethics

Synopsis

In its 2000 Annual Report, Enron prided itself on having “metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people.”¹ Enron’s strategy seemed to pay off. In 2000, it was the seventh largest company on the Fortune 500, with assets of $65 billion and sales revenues of over $100 billion.² From 1996 to 2000,


Enron’s revenues had increased by more than 750 percent (over 65 percent per year), which was unprecedented in any industry.\(^3\) Yet, just a year later, Enron filed for bankruptcy, and billions of shareholder dollars and retirement savings were lost.

In 2002, Enron’s auditor Arthur Andersen LLP, one of the five largest international public accounting firms, was convicted on one charge of obstruction of justice in connection with the Enron audit. And although this conviction was overturned in 2005 by the United States Supreme Court, Andersen’s decision to destroy evidence cast suspicion on whether Andersen was trying to cover up any guilt related to a failure to perform its professional responsibilities.

**Arthur Andersen**

Enron paid Arthur Andersen $46.8 million in fees for auditing, business consulting, and tax work for the fiscal year ended August 31, 1999; $58 million in 2000; and more than $50 million in 2001.\(^4\) Andersen was collecting a million dollars a week from Enron in the year before its crash. Enron was one of Andersen’s largest clients.

More than half of that amount was for fees that were charged for nonaudit services.\(^5\) In 2000, for example, Enron paid Andersen $25 million for audit services, and $27 million for consulting and other services, such as internal audit services.\(^6\)

In fact, Andersen had performed Enron’s internal audit function since 1993. That year, Andersen had hired 40 Enron personnel, including the vice president of internal audit, to be part of Andersen’s team providing internal audit

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In 2000, as SEC chairman Arthur Levitt was trying to reform the industry practice of an audit firm also offering consulting services to their audit clients, Enron’s Chairman and Chief Executive Officer Ken Lay sent a letter to Levitt (the letter was secretly coauthored by Andersen partner David Duncan), in which he wrote:

While the agreement Enron has with its independent auditors displaces a significant portion of the activities previously performed by internal resources, it is structured to ensure that Enron management maintains appropriate audit plan design, results assessment and overall monitoring and oversight responsibilities … Enron has found its “integrated audit” arrangement to be more efficient and cost-effective than the more traditional roles of separate internal and external auditing functions.8

Interestingly, at Andersen, an audit partner’s compensation depended in large part on his or her ability to sell other services (in addition to auditing) to clients.9 Therefore, the nonaudit services provided to Enron had a big impact on the salary of the lead Andersen partner on the Enron engagement, David Duncan, who was earning around $1 million a year.10

Close Ties between Enron and Andersen

After graduating from Texas A&M University, Duncan joined Andersen in 1981, made partner in 1995, and was named the lead partner for Enron two years later. Duncan developed a close personal relationship with Enron’s Chief Accounting Officer Richard Causey, who himself had worked at Arthur Andersen for almost nine years. Duncan and Causey often went to lunch together, and their families had even taken vacations together.11

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Causey, who came to Enron in 1991, was appointed Chief Accounting Officer in 1997. Causey was responsible for recruiting many Andersen alumni to work at Enron. Over the years, Enron hired at least 86 Andersen accountants.\textsuperscript{12} Several were in senior executive positions, including Jeffrey McMahon, who had served as Enron’s treasurer and president, and Vice President Sherron Watkins.

Although Andersen had separate offices in downtown Houston, Duncan and up to one hundred Andersen managers had a whole floor available to them within Enron’s headquarters in Houston.\textsuperscript{13} Duncan once remarked that he liked having the office space there because it “enhanced our ability to serve” and to “generate additional work.”\textsuperscript{14} Andersen boasted about the closeness of their relationship in a promotional video. “We basically do the same types of things … We’re trying to kinda cross lines and trying to, you know, become more of just a business person here at Enron,” said one accountant. Another spoke about the advantage of being located in Enron’s building: “Being here full-time, year-round, day-to-day gives us a chance to chase the deals with them and participate in the deal making process…”\textsuperscript{15}

In fact, Andersen and Enron employees went on ski trips and took annual golf vacations together. They played fantasy football against each other on their office computers and took turns buying each other margaritas at a local Mexican restaurant chain. One former senior audit manager at Andersen said that it was “like these very bright geeks at Andersen suddenly got invited to this really cool, macho frat party.”\textsuperscript{16}


\textsuperscript{15} Bethany McLean and Peter Elkind, \textit{The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron} (Penguin Group, 2003), p. 146.

Case Questions

1. What is auditor independence and what is its significance to the audit profession? What is the difference between independence in appearance and independence in fact?

2. Please consult Paragraph 32 of PCAOB Auditing Standard No. 2. In what ways, if any, was Arthur Andersen’s independence in fact or in appearance potentially impacted on the Enron audit?

3. Refer to Section 201 of SOX. Please identify the services provided by Arthur Andersen that are no longer allowed to be performed. Do you believe that Section 201 was needed? Why or why not?

4. Please refer to Section 203 and Section 206 of SOX. How would these sections of the law have impacted the Enron audit? Do you believe that these sections were needed? Why or why not?
Case 1.2

Enron: A Focus on Quality Assurance

Synopsis

In its 2000 Annual Report, Enron prided itself on having “metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people.”\(^{17}\) Enron’s strategy seemed to pay off. In 2000, it was the seventh largest company on the Fortune 500, with assets of $65 billion and sales revenues of over $100 billion.\(^{18}\) From 1996 to 2000, Enron’s revenues had increased by more than 750 percent (over 65 percent per year), which was unprecedented in any industry.\(^{19}\) Yet, just a year later, Enron filed for bankruptcy, and billions of shareholder dollars and retirement savings were lost.

In 2002, Enron’s auditor Arthur Andersen LLP, one of the five largest international public accounting firms, was convicted on one charge of obstruction of justice in connection with the Enron audit. And although this conviction was overturned in 2005 by the United States Supreme Court, Andersen’s decision to destroy evidence cast suspicion on whether Andersen was trying to cover up any guilt related to a failure to perform its professional responsibilities.

Andersen’s Professional Standard Group

In addition to shredding documents, Andersen employees also allegedly changed memos that had been previously issued. These memos illustrated conflicts that existed between Andersen’s group of expert accountants tasked with

\(^{17}\) Enron 2000 Annual Report, p. 7.


reviewing and passing judgment on difficult accounting, auditing, and tax issues—the Professional Standards Group (PSG)—and the Enron audit team. The PSG had objected strongly to several accounting issues related to the Enron audit. Their objections had been overruled by the lead Andersen partner on the Enron audit, David Duncan. The memos seemed to indicate that Duncan’s team had misrepresented PSG’s judgments to indicate their approval of Enron’s accounting. In addition, Duncan allegedly helped carry out Enron’s request to have one of the PSG partners removed from advising on any issues related to the Enron audit.20

**PSG’s Disapproval of Special Purpose Entities and the Audit Team’s Response**

In 1999, Enron’s Chief Financial Officer, Andrew Fastow, spoke to David Duncan about Enron’s plan to set up a special purpose entity (later called LJM), a financing vehicle used to access capital or increase leverage without adding debt to a firm’s balance sheet. After the discussion with Fastow, Duncan asked for the advice of the PSG.

A member of the PSG, Benjamin Neuhausen, represented the group’s disapproval in an e-mail written to Mr. Duncan on May 28, 1999: “Setting aside the accounting, (the) idea of a venture equity managed by CFO is terrible from a business point of view…. Conflicts of interest galore. Why would any director in his or her right mind ever approve such a scheme?” he wrote.21

In addition, PSG was firmly against the idea of Enron’s recording gains on the sales of assets (or immediate gains on any transactions) to the Fastow-controlled special purpose entity. In response to the recording of gains, Duncan wrote in a June e-mail: “I’m not saying I’m in love with this either … But I’ll need all the ammo I can get to take that issue on … on your point 1, (i.e. the whole thing is a bad idea), I really couldn’t agree more.” Yet, Duncan later told Mr. Fastow that Andersen would sign off on the transaction, under a few conditions, one of which was that

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Mr. Fastow obtained the approval of Enron’s chief executive and its Board of Directors.  

Shortly after, Carl Bass, who was promoted to PSG in December 1999, raised concerns over the sale of some equity options within the LJM special purpose entity. Bass wrote to his boss John Stewart in an e-mail, “This is a big item and the team apparently does not want to go back to the client on this. I think at a minimum the Practice Director needs to be made aware of this history and our opposition to the accounting.” However, the memo Duncan’s team prepared to document the deal indicated that Bass “concurred with our conclusions.”

Bass continued to object to the LJM transaction, writing in an e-mail to Stewart (Bass’s boss) in February 2000: “This whole deal looks like there is no substance. The only money at risk here is $1.8 million in a bankrupt proof special purpose entity (SPE). All of the money here appears to be provided by Enron….” Duncan’s team did not address Bass’s concerns and, in fact, continued to misrepresent his views to the client.

In late 2000, Duncan asked Bass for more advice on how best to account for four Enron SPEs known as Raptors. Enron wanted to lump together the financial results for all the entities, so that the more profitable ones could offset losses being garnered by others. Bass opposed the idea. Nevertheless, Duncan later decided that Andersen would “accept the client’s position,” with some modifications.

In February 2001, Andersen held a routine annual risk-assessment meeting to determine whether to keep Enron as a client. Some partners raised concerns related to how much debt Enron was not putting on its balance sheet,

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Fastow’s conflict of interest, and the lack of disclosure in the company’s financial footnotes. Duncan reassured his fellow partners.

Carl Bass was removed from the Enron account in March 2001. Bass wrote to Stewart (Bass’s boss) in an e-mail: “Apparently, part of the process issue stems from the client (Enron) knowing all that goes on within our walls on our discussions with respect to their issues…. We should not be communicating with the client that so and so said this and I could not get this past so and so in the PSG…. I have first hand experience on this because at a recent EITF meeting some lower level Enron employee who was with some else [sic] from Enron introduced herself to me by saying she had heard my name a lot— ‘so you are the one that will not let us do something…. ’ I have also noted a trend on this engagement that the question is usually couched along the lines ‘will the PSG support this?’ When a call starts out that way, it is my experience that the partner is struggling with the question and what the client wants to do.” Stewart complained to a senior partner about Bass’s removal. Duncan called Mr. Stewart and explained that two Enron executives, Richard Causey and John Echols, had pushed for Bass’s removal.

* * *

In October 2001, Enron announced that it had a loss of $600 million and a reduction of shareholder equity of $1.2 billion in its third quarter of that year; and that the SEC was conducting an investigation into an issue related to one of its partnerships. At that time, Bass discovered the memos written by the audit team that claimed he agreed with Enron’s accounting. Bass asked that some of the memos be changed to reflect his true judgments. In November, Enron announced that it would need to restate its financial statements for the previous five years to


account for $586 million in losses.\textsuperscript{31}

\textbf{Case Questions}

1. Please explain why an accounting and auditing research function (like Andersen’s PSG) is important in the operations of a CPA firm. What role does the function play in completing the audit?

2. Please consult Section 103 of SOX. Do you believe that the Engagement Leader of an Audit (like David Duncan on the Enron audit) should have the authority to overrule the opinions and recommendations of the accounting and auditing research function (like the PSG)? Why or why not? Do you think that a PCAOB inspector would approve of this practice?

3. After Carl Bass was removed from the Enron account, he indicated to his boss that he did not believe Enron should have known about internal discussions regarding accounting and auditing issues. Do you agree with Bass’s position? Why or why not?

4. Please consult Section 203 of SOX. Do you believe that this provision of the law goes far enough, that is, do you believe the audit firm itself (and not just the partner) should have to rotate off an audit engagement every five years? Why or why not?

\textsuperscript{31} It was also foreshadowed by Enron’s announcement in October 2001 that it had a loss of $600 million and a reduction of shareholder equity of $1.2 billion in its third quarter of that year; and that the SEC was conducting an investigation into an issue related to one of its partnerships.
Case 1.3

Waste Management: A Focus on Ethics and Due Professional Care

Synopsis

In February 1998, Waste Management announced it was restating the financial statements it had issued for the years 1993 through 1996. In its restatement, Waste Management said it had materially overstated its reported pretax earnings by $1.43 billion. After the announcement, the company’s stock dropped by more than 33 percent and shareholders lost over $6 billion.

The SEC brought charges against the company’s founder Dean Buntrock and five other former top officers. The charges alleged that management had made repeated changes to depreciation-related estimates to reduce expenses and had employed several improper accounting practices related to capitalization policies, also designed to reduce expenses.32

Background

Because the financial statements for the years 1993 through 1996 were not presented in conformity with Generally Accepted Accounting Principles (GAAP), Waste Management’s independent auditor, Arthur Andersen, came under scrutiny for issuing unqualified opinions on the financial statements for these years. The SEC filed suit against Andersen on charges that it knowingly or recklessly issued materially false and misleading audit reports for the period 1993 through 1996. Andersen ultimately settled with the SEC for $7 million, the largest-ever civil penalty at the time, without admitting or denying any allegations or findings.33 Three Andersen partners who worked on the

32 SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).

Waste Management audit during this period also received sanctions from the SEC.

**Waste Management’s Relationship with Arthur Andersen**

Even before Waste Management became a public company in 1971, Arthur Andersen served as the company’s auditor. In the early nineties, Waste Management capped Andersen’s corporate audit fees at the prior year’s level, although it did allow the firm to earn additional fees for “special work.” Between 1991 and 1997, Andersen billed Waste Management approximately $7.5 million in financial statement audit fees. During this seven-year period, Andersen also billed Waste Management $11.8 million in fees related to other professional services.

During the nineties, approximately 14 former Andersen employees worked for Waste Management. While at Andersen, most of these individuals worked in the group responsible for auditing Waste Management’s financial statements prior to 1991, and all but a few had left Andersen more than ten years before the 1993 financial statement audit began.

In fact, until 1997, every chief financial officer (CFO) and chief accounting officer (CAO) at Waste Management since it became public had previously worked as an auditor at Andersen. Waste Management’s CAO and corporate controller from September 1990 to October 1997, Thomas Hau, was a former Andersen audit engagement partner for the Waste Management account. At the time Hau left Andersen, he was the head of the division within Andersen responsible for conducting Waste Management’s annual audit, but he was not the engagement partner at that time.

**Andersen’s Partners on the Waste Management Audit**

In 1991, Andersen assigned Robert Allgyer, a partner at Andersen since 1976, to become the audit engagement partner for the Waste Management audit. Allgyer held the title of Partner-in-Charge of Client Service and he also served as the marketing director for Andersen’s Chicago office. Among the reasons for Allgyer’s selection as

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35 Ibid.

36 Ibid.


38 Ibid.
engagement partner were his “extensive experience in Europe,” his “devotion to client service,” and his “personal style that … fit well with the Waste Management officers.” In setting Allgyer’s compensation, Andersen took into account fees earned for audit and nonaudit services. Walter Cercavschi, who was a senior manager when he started working on the Waste Management engagement team in the late eighties, also remained on the engagement after becoming a partner in 1994.

In 1993, Edward Maier became the concurring partner on the engagement. As concurring partner, Maier’s duties included reading the financial statements, discussing significant accounting, auditing, or reporting issues with the engagement partner; reviewing certain key working papers (such as the audit risk analysis, final engagement memoranda, summaries of proposed adjusting entries); and inquiring about matters that could have a material effect on the financial statements or the auditor’s report. Maier also served as the risk management partner for the Chicago office in charge of supervising the client acceptance and retention processes for the entire office.

**Andersen’s Proposed Adjusting Journal Entries**

In early 1994, the Andersen engagement team quantified several current and prior period misstatements and prepared Proposed Adjusting Journal Entries (PAJEs) in the amount of $128 million for Waste Management to record in 1993. If recorded, this amount would have reduced net income before special items by 12 percent. The engagement team also identified other accounting practices that gave rise to other (known and likely) misstatements primarily resulting in the understatement of operating expenses.

Allgyer and Maier consulted with Robert Kutsenda, the Practice Director responsible for Andersen’s Chicago, Kansas City, Indianapolis, and Omaha offices, about this issue. Kutsenda and the Audit Division Head, who was also consulted, determined that the misstatements were not material and that Andersen could, therefore, issue an unqualified audit report on the 1993 financial statements. Nevertheless, the team did instruct Allgyer to inform management that Andersen expected the company to change its accounting practices and to reduce the cumulative

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39 Ibid.
40 Ibid.
41 Ibid.
42 Ibid.
amount of the PAJEs in the future.43 After consulting with the Managing Partner of the firm, Allgyer proposed a “Summary of Action Steps” to reduce the cumulative amount of the PAJEs, going forward, and to change the accounting practices that gave rise to the PAJEs, as well as to the other known and likely misstatements.44

Although Waste Management agreed to the Summary of Action Steps, the company continued to engage in the accounting practices that gave rise to the PAJEs and the other misstatements. Nevertheless, Andersen’s engagement team continued to issue unqualified audit reports on Waste Management’s financial statements, despite their failure to make progress on the PAJEs.

**Case Questions**

1. Please consult Paragraph 32 of PCAOB Auditing Standard No. 2. In what ways was Arthur Andersen’s independence, in fact or in appearance, potentially impacted on the Waste Management audit, if any?

2. Considering the example in the Waste Management case, please explain why a review by the Practice Director and the Audit Division Head is important in the operations of a CPA firm. In your opinion, was this review effective in the present context, at Waste Management? Why or why not?

3. Please explain what is meant by PAJEs. Do you believe that Andersen’s final decision regarding the PAJE’s was appropriate, under the circumstances? Would your opinion change if you knew that all of the adjustments were based on subjective differences (e.g., a difference in the estimate of the allowance for doubtful accounts), as compared to objective differences (e.g., a difference in the account receivable balance of their biggest customer)?

4. Please refer to Section 203 and Section 206 of SOX. How would these sections of the law have impacted the Waste Management audit? Do you believe that these sections were needed? Why or why not?

43 Ibid.

44 Ibid.
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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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:\textsuperscript{49}

\textsuperscript{46} Board of Directors’ Special Investigative Committee Report, June 9, 2003, 225.

\textsuperscript{47} Board of Directors’ Special Investigative Committee Report, June 9, 2003, 225.

\textsuperscript{48} Board of Directors’ Special Investigative Committee Report, June 9, 2003, 246–248.

\textsuperscript{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.\(^\text{50}\)

**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.\(^\text{51}\)

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.\(^\text{52}\) 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.\(^\text{53}\) In all, the Special Investigative Committee found hundreds of large, round-dollar journal


\(^{51}\) Board of Directors’ Special Investigative Committee Report, June 9, 2003, 27.


\(^{53}\) 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.

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54 Board of Directors’ Special Investigative Committee Report, June 9, 2003, 228.
Case 1.5

Sunbeam: A Focus on Ethics and Due Professional Care

Synopsis

In April 1996, Sunbeam named Albert J. Dunlap as its CEO and Chairman. Formerly with Scott Paper Co., Dunlap was known as a turnaround specialist and was even nicknamed “Chainsaw Al” because of the cost-cutting measures he typically employed. Almost immediately, Dunlap began replacing nearly all of the upper management team and led the company into an aggressive corporate restructuring that included the elimination of half of its 12,000 employees and the elimination of 87 percent of Sunbeam’s products.

Unfortunately, in May 1998, Sunbeam disappointed investors with its announcement that it had earned a worse-than-expected loss of $44.6 million in the first quarter of 1998.55 CEO and Chairman Dunlap was fired in June 1998. In October 1998, Sunbeam announced that it would need to restate its financial statements for 1996, 1997 and 1998.56

Independent Auditor Arthur Andersen

Sunbeam’s auditor, Arthur Andersen, came under fire for having issued an unqualified opinion on the company’s financial statements for both 1996 and 1997. In January 1999, a class action lawsuit alleging violation of the federal securities laws was filed in the U.S. District Court for the Southern District of Florida against Sunbeam, Arthur Andersen, and Sunbeam executives. The suit reached the settlement stage in 2001. As part of the settlement, Andersen agreed to pay $110 million.57

Not surprisingly, Phillip Harlow the engagement Partner-in-Charge of the Sunbeam audit during this time period


also found himself under fire on an individual basis for his work on the audits. The Securities and Exchange Commission (SEC) barred Harlow from serving as a public accountant for three years after it found that Harlow failed to exercise professional care in performing the audits of Sunbeam’s financial statements.\(^{58}\)

**1996 Audit**

Through the course of the 1996 audit, Andersen Partner Phillip Harlow allegedly became aware of several accounting practices that failed to comply with GAAP. In particular, he allegedly knew about Sunbeam’s improper restructuring costs, excessive litigation reserves, and an excessive “cooperative advertising” figure.

**Improper Restructuring Costs**

During the 1996 audit, Harlow allegedly identified $18.7 million in items within Sunbeam’s restructuring reserve that were improperly classified as restructuring costs because they benefited Sunbeam’s future operations. Harlow proposed that the company reverse the improper accounting entries, but management rejected his proposed adjustments for these entries. Harlow relented on his demand after deciding that the items were immaterial for the 1996 financials.\(^{59}\)

**Excessive Litigation Reserves**

Sunbeam also failed to comply with GAAP on a $12 million reserve recorded for a lawsuit that alleged Sunbeam’s potential obligation to cover a portion of the cleanup costs for a hazardous waste site. Management did not take appropriate steps to determine whether the amount reflected a probable and reasonable estimate of the loss, as required by GAAP. Had they done so, the reserve would not have passed either of the criteria. Harlow relied on statements from Sunbeam’s General Counsel and did not take additional steps to determine whether the litigation reserve level was in accordance with GAAP.\(^{60}\)

**Excessive “Cooperative Advertising” Reserve**

Sunbeam also recognized an excessive figure for a “cooperative advertising” reserve established to fund a portion of

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its retailers’ costs of running local promotions. At an amount of $21.8 million, the reserve was approximately 25 percent higher than the prior year’s accrual amount, without a proportional increase in sales. Harlow accepted management’s representations that the accrual was an appropriate figure and did not ask for additional documentation to test the amount.\footnote{Ibid., 7\textendash}8.}

**1997 Audit**

Harlow also allegedly discovered several items that were not compliant with GAAP during the course of the 1997 audit. These items related to revenue, the restructuring reserves, and inventory, in particular. In several cases, he made proposed adjustments that management refused to make. In response to management’s refusal, Harlow acquiesced, however. By the end of 1997, it appears Harlow knew that approximately 16 percent of Sunbeam’s reported 1997 income came from items he found to be not in accordance with GAAP.\footnote{“Complaint for Civil Injunction and Civil Penalties,” SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 7\textendash}8. In fact, at least $62 million of Sunbeam’s reported $189 million of income before tax failed to comply with GAAP.\footnote{SEC Accounting and Auditing Enforcement Release No. 1393, May 15, 2001.} The following examples illustrate two of the different techniques used by Sunbeam to overstate revenue earned.

**Bill and Hold Sales**

The SEC found that Harlow “knew or recklessly disregarded facts, indicating that the fourth-quarter bill and hold transactions did not satisfy required revenue recognition criteria.”\footnote{“Complaint for Civil Injunction and Civil Penalties,” SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 32\textendash}33. Among other things, Sunbeam's revenues earned through bill and hold sales should not have been recognized because these sales were not requested by Sunbeam’s customers, and they served no business purpose other than to accelerate revenue recognition by Sunbeam. Sunbeam offered its customers the right to return any unsold product. Further, several of Sunbeam’s bill and hold transactions were also characterized by Sunbeam offering its customers financial incentives, such as discounted pricing, to write
purchase orders before they actually needed the goods.\(^{65}\)

**Sale of Inventory**

Sunbeam’s fourth-quarter revenue included $11 million from a sale of its spare parts inventory to EPI Printers, which, prior to this transaction, had satisfied spare parts and warranty requests for Sunbeam’s customers on an as-needed basis. As part of the transaction, Sunbeam agreed to pay certain fees and guaranteed a 5 percent profit for EPI Printers on the resale of the inventory. The contract with EPI printers also stipulated that it would terminate in January 1998 if the parties did not agree on the value of the inventory underlying the contract.

Harlow allegedly knew that revenue recognition on this transaction did not comply with GAAP due to the profit guarantee and the indeterminate value of the contract. Thus, Harlow proposed an adjustment to reverse the accounting entries that reflected the revenue and income recognition for this transaction. Yet, Harlow acquiesced to management’s refusal to reverse the sale.\(^{66}\)

**Case Questions**

1. Please consider the alleged accounting improprieties related to increased expenses from the 1996 audit. If you were auditing Sunbeam, what type of evidence would you like to review to determine whether Sunbeam had recorded the litigation reserve amount and the cooperative advertising amount in accordance with GAAP?

2. For the excessive litigation reserves and excessive “cooperative advertising” amount, please identify the journal entry that is likely to have been proposed by Andersen to correct each of these accounting improprieties. Why would Sunbeam be interested in recording journal entries that essentially reduced their income before tax in 1996?

3. As discussed in the case, during both the 1996 and the 1997 audit, Phillip Harlow allegedly discovered a number of different accounting entries made by Sunbeam that were not compliant with GAAP. Please speculate about how Mr. Harlow may have explained his decision not to require Sunbeam to correct these alleged misstatements in the audit working papers.

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4. Consult Section 204 of SOX and Paragraphs 55–59 of PCAOB Auditing Standard No. 2. In the post-Sarbanes audit environment, which of the issues that arose in 1996 and 1997 would have to be reported to the audit committee at Sunbeam? Do you believe that communication to the audit committee would have made a difference in Mr. Harlow’s decision not to record the adjusting journal entries? Why or why not?
Case 1.6

The Fund of Funds: A Focus on Independence

Synopsis

As total assets reached $617 million in 1967, The Fund of Funds (FOF) was the most successful of the mutual funds offered by the Investor Overseas Services, Limited. In the late 1960s, FOF diversified into natural-resource asset investments. To do so, it formed a relationship with John King, a Denver oil, gas, and mineral investor and developer, whereby FOF would purchase oil and gas properties directly from his company, King Resources. By the 1970s, FOF was forced into bankruptcy.

It was later uncovered that King Resources had dramatically overcharged FOF for the properties that it sold to FOF. FOF’s bankruptcy trustee sued Arthur Andersen for failing to inform FOF that they were being defrauded by King Resources. Arthur Andersen was ultimately found liable and forced to pay around $70 million in civil damages, while John King was charged and convicted for masterminding the fraud against FOF.

National Resources Fund Account

FOF incorporated FOF Proprietary Funds, Ltd. (FOF Prop) as an umbrella for specialized investment accounts that were managed by its investment advisors. Each of FOF Prop’s investment advisors had a duty to act in FOF’s best interests and to avoid conflicts of interest. Each was compensated based on the realized and unrealized (paper) appreciation of their portfolios.67

One of FOF’s specialized investment accounts was the National Resources Fund Account (NRFA), which was dedicated to investments in oil, gas, and mineral assets. Although no formal written agreement established the King Resources Corporation (KRC) as the investment advisor for the NRFA, FOF’s intent was to use KRC’s expertise, as it did that of other investment advisors, to locate and purchase speculative natural resource investments. FOF also

had no means of valuing the assets proposed for investment and no means of participating in any of the work requirements.\(^{68}\) Importantly, King’s own corporate documents clearly represented that KRC was an investment advisor to FOF.

**Andersen’s Relationships with FOF and KRC\(^{69}\)**

Both KRC and FOF, including its NRFA, were audited by Arthur Andersen. Andersen also audited John King’s personal accounts. The partner-in-charge and the manager of the KRC audit held the same respective positions on the NRFA audit, and other Andersen staffers sometimes worked contemporaneously on the KRC and the NRFA audits. In addition, Andersen used records from KRC to perform its audit of the NRFA. Andersen’s auditors possessed minutes of an FOF Board of Directors meeting describing the NRFA as “essentially a discretionary account managed by King Resources Corporation.” Andersen’s auditors themselves noted KRC’s “carte blanche authority to buy oil and gas properties for [NRC]” and its “quasi-fiduciary” duty to FOF.

Prior to the year-end 1968 KRC audit, and as early as 1966, Andersen viewed John King and his companies as a difficult client, one that posed risks to the firm itself. In fact, Andersen personnel had repeated, serious difficulties with John King as a client since at least 1961. For example, Mr. King often spoke directly with the highest echelon of the Andersen partnership in Chicago when he was displeased with the Denver office’s resolution of certain issues. Andersen also viewed FOF as presenting its own set of problems and risks.

In addition to performing a substantial amount of work on the audit of NRFA for FOF, Andersen’s Denver office had primary responsibility for the KRC audits. Therefore, Andersen’s Denver office was well aware of the advisory relationship between KRC and FOF because the relationship was described in KRC filings with the SEC. The Denver office was also aware of the lack of a written contract evidencing the terms of the relationship between


KRC and FOF. In addition, it sought confirmation of the nature of any KRC-FOF agreement from KRC for the KRC audit, although it surprisingly did not seek such a confirmation from FOF with respect to the NRFA audit.

As part of its primary responsibility for the audits of the NRFA occurring after year end 1968, the Denver office of Andersen determined the cost value of NRFA purchases by examining the books of KRC as evidential matter. Andersen only reviewed the valuations set by KRC to assess whether they were presented in accordance with FOF’s guidelines, and it did not determine the market value of the NRFA interests as part of the FOF audit scope.

**Andersen’s Relationship with Key Third Parties**

FOF was required to value its investment portfolio on a daily basis because it redeemed shares on the basis of its daily share value. The daily share value was determined by dividing the net asset value of FOF’s entire portfolio by the number of outstanding shares.

FOF relied exclusively on the advice of KRC for the initial valuations and subsequent revaluations of its natural resource assets. Natural resource asset valuations were challenging due to their speculative nature and the lack of an active trading market for determining current realizable value. Thus, in some cases, KRC arranged for sales of percentages of certain assets to third parties to help determine valuations of those assets or to justify revaluations. In some instances, Andersen was also the independent auditor for the third parties.

For example, in late 1969, King arranged for a sale of 9.375 percent of his group’s Arctic interest to John Mecom and Consolidated Oil & Gas (COG) to help justify a revaluation for FOF. In fact, this sale was the basis for the $119 million upward revaluation of the remainder of FOF’s Arctic interest. Mecom, a wealthy Texan who owned U.S. Oil of Louisiana, Inc., had lost $11,458,000 for the year ending September 30, 1969, and reported debts of over $132,000,000. As a result of Mecom’s cash problems, King agreed to provide the $266,000 down payment for the Arctic transaction, with the subsequent $10 million in payments provided by KRC’s use of Mecom-owned oil and

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drilling equipment. Andersen audited Mecom from its Houston office.\textsuperscript{71}

**Case Questions**

1. What is auditor independence and what is its significance to the audit profession? What is the difference between independence in appearance and independence in fact?

2. Consider that both KRC and FOF, including its NRFA, were audited by Arthur Andersen. In addition, Arthur Andersen audited King’s personal accounts. Do you believe these relationships impair the independence of Arthur Andersen? Why or why not?

3. Would your answer be any different if the fact pattern changed so that different partners were assigned to both the KRC audit and the NRFA audit? Please assume that both audit teams were completely different. Why or why not would your answer be different?

4. Consult Paragraphs #32–35 of PCAOB Auditing Standard No. 2. Based on the case information, do you believe that Arthur Andersen violated any of the four basic principles of auditor independence described? Why or why not?

5. Refer to Sections 201, 203, and 206 of SOX. Based on your understanding of the FOF audit, do you believe these sections were needed? Why or why not? Be specific.

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\textsuperscript{71} In February 1968, Leonard Spacek, Andersen’s managing partner, met with King and Mecom to discuss integration of the King and Mecom organizations. Spacek also discussed a role for KRC in refinancing Mecom’s debts in May 1968 and, in December 1968, Spacek discussed the possibility of a King-Mecom joint venture with the Houston office of AA.
Section 2

Understanding the Client’s Business and Industry

To identify areas of elevated risk on the audit, an auditor must take great care to understand the client’s business, industry, and, ultimately, their strategy to achieve competitive advantage in that industry. Because it can often be difficult for auditors to make the connection between a client’s strategic direction and the identification of significant audit risks, the cases in this section are designed to provide a mechanism to illustrate the explicit linkage between a client’s strategic direction and the identification of significant audit risks.

The case readings have been developed solely as a basis for class discussion. The case readings are not intended to serve as a source of primary data or as an illustration of effective or ineffective auditing.

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Case 2.1

Enron: A Focus on Fraud and Inherent Risk Assessment

Synopsis

In its 2000 Annual Report, Enron prided itself on having “metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people.”72 Enron’s strategy seemed to pay off. In 2000, it was the seventh largest company on the Fortune 500, with assets of $65 billion and sales revenues of over $100 billion.73 From 1996 to 2000, Enron’s revenues had increased by more than 750 percent (over 65 percent per year), which was


unprecedented in any industry. Yet, just a year later, Enron filed for bankruptcy, and billions of shareholder dollars and retirement savings were lost.

In 2002, Enron’s auditor Arthur Andersen LLP, one of the five largest international public accounting firms, was convicted on one charge of obstruction of justice in connection with the Enron audit. And although this conviction was overturned in 2005 by the United States Supreme Court, Andersen’s decision to destroy evidence cast suspicion on whether Andersen was trying to cover up any guilt related to a failure to perform its professional responsibilities.

Origins of Enron

Enron was created in 1985 by the merger of two gas pipeline companies: Houston Natural Gas and InterNorth. Enron’s mission was to become the leading natural-gas pipeline company in North America. As several changes occurred in the natural gas industry in the mid-1980s, Enron adapted and changed its mission, expanding into natural gas trading and financing, as well as into other markets, such as electricity and other commodity markets.

Enron’s First Few Years

In 1985, Enron had assets along the three major stages of the supply chain of natural gas: production, transmission, and distribution. Natural gas was “produced” from deposits found underground. The natural gas was transmitted via pipelines, or networks of underground pipes, either directly to industrial customers or sold to regional gas utilities, which then distributed it to smaller businesses and customers. Some companies in the industry had assets related to specific activities within the supply chain. For example, some companies owned pipelines, but did not produce their own gas. These companies often entered into long-term “take or pay” contracts, whereby they paid for minimum volumes in the future at prearranged prices, to protect against supply shortages.

In early 1986, Enron reported a loss of $14 million for its first year. As a result, the company employed a series of cost-cutting measures, including layoffs and pay freezes for top executives. Enron also started selling off assets to reduce its debt. Nevertheless, Enron’s financial situation was still bleak in 1987. That year, Moody’s downgraded its

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credit rating to “junk bond” status.\textsuperscript{75}

**Impact of Significant Industry Change on Enron**

Enron faced significant change in its industry environment due to the government’s decision in the mid-1980s to deregulate the once highly regulated industry. The government, which had dictated the price pipeline companies paid for gas and the price they could charge their customers, decided to allow the market forces of supply and demand to dictate prices and volumes sold. As part of this process, the government required that pipeline companies provide “open access” to their pipelines to other companies wanting to transport natural gas, so that pipeline companies would not have an unfair competitive advantage.\textsuperscript{76}

**Enron’s Natural Gas Pipeline Business**

Enron adapted by providing “open access” to its pipelines, i.e., charging other firms for the right to use them. Enron also took advantage of the ability to gain “open access” to pipelines owned by other companies. For example, in 1988, Enron signed a 15-year contract with Brooklyn Union to supply gas to a plant being built in New York. Because Brooklyn Union was not connected to Enron’s pipeline system, Enron needed to contract with another pipeline company to transport the gas to Brooklyn Union. Enron was, therefore, assuming added risks related to the transportation of the gas. The long-term nature of the contract was also risky because prices could rise to a level that would make the contract unprofitable.\textsuperscript{77}

**Enron Expands into Natural Gas Trading and Financing**

Enron capitalized on the introduction of market forces into the industry by becoming involved in natural gas trading and financing. Enron served as an intermediary between producers who contracted to sell their gas to Enron and gas customers who contracted to purchase gas from Enron. Enron collected as profits the difference between the prices at


which it sold the gas less the prices at which it purchased the gas. Enron’s physical market presence (i.e., owning the pipelines and charging a price for distribution that was proportional to the spot price of gas it might purchase) helped to mitigate the risk of a price increase of the gas it was purchasing.\footnote{Christopher L. Culp and Steve H. Hanke, “Empire of the Sun: An Economic Interpretation of Enron’s Energy Business,” \textit{Policy Analysis}, No. 470, February 20, 2003, p. 6.}

In response to the problem of getting producers to sign long-term contracts to supply gas, Enron started giving such producers cash up-front instead of the payment over the life of the contract. Enron then allowed for the natural gas contracts it devised—which were quite complex and variable, depending on different pricing, capacity, and transportation parameters—to be traded.

**Enron Expands beyond Natural Gas**

Enron decided to apply its gas-trading model to other markets, branching out into electricity and other commodity markets, such as paper and chemicals. To accomplish its expansion strategy, it sought to pursue an “asset light” strategy. Enron’s goal was to achieve the advantages of having a presence in the physical market, without the disadvantages of huge fixed capital expenditures. For example, in natural gas, Enron divested its assets related to pumping gas at the wellhead or to selling gas to customers, and then set out to acquire assets related to midstream activities, such as transportation, storage, and distribution.\footnote{Christopher L. Culp and Steve H. Hanke, “Empire of the Sun: An Economic Interpretation of Enron’s Energy Business,” \textit{Policy Analysis}, No. 470, February 20, 2003, p. 7.} By late 2000, Enron owned 5,000 fewer miles of natural gas pipeline than when founded in 1985; in fact, Enron’s gas transactions represented 20 times its existing pipeline capacity.\footnote{Paul M. Healy and Krishna Palepu, “Governance and Intermediation Problems in Capital Markets: Evidence from the Fall of Enron,” Harvard NOM Research Paper No. 02–27, August 2002, pp. 9–10.}

In addition, Enron undertook international projects involving the construction and management of energy facilities outside the United States—in the United Kingdom, Eastern Europe, Africa, the Middle East, India, China, and Central and South America. Established in 1993, the Enron International Division did not adhere to the asset-light strategy pursued by other divisions. Enron also expanded aggressively into broadband, the use of fiber optics to transmit audio and video. Among its goals in that business were to deploy the largest open global broadband network
Case Questions

1. Based on your understanding of inherent risk assessment, please identify three specific factors about Enron’s business model in the late 1990s that are likely to impact your audit procedures if you were conducting an audit of the financial statements at Enron.

2. Please consult Q39 and Q43 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of the inherent risks identified at Enron (in Question #1) would influence the nature, timing, and extent of your audit work at Enron.

3. Please consult Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Consider how the change in industry regulation and Enron’s resulting strategy shift would impact your inherent risk assessment for the relevant financial statement assertions about the revenue account. Specifically, please explain why your understanding of Enron’s strategy impacts such inherent risk assessment.

4. Consult Paragraph #24 of PCAOB Auditing Standard No. 2 and SAS No. 99. Please brainstorm about how a revenue recognition fraud might occur under Enron’s strategy in the late 1990s. Can you think of a control procedure that would prevent, detect, or deter such a fraud?

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Case 2.2

Waste Management: A Focus on Fraud and Inherent Risk Assessment

Synopsis

In February 1998, Waste Management announced that it was restating the financial statements it had issued for the years 1993 through 1996. In its restatement, Waste Management said that it had materially overstated its reported pretax earnings by $1.43 billion. After the announcement, the company’s stock dropped by more than 33 percent and shareholders lost over $6 billion.

The SEC brought charges against the company’s founder Dean Buntrock and five other former top officers. The charges alleged that management had made repeated changes to depreciation related estimates to reduce expenses and had employed several improper accounting practices related to capitalization policies, also designed to reduce expenses.\(^\text{82}\)

History

In 1956, Dean Buntrock took control of Ace Scavenger, a garbage collector that was owned by his then father-in-law who had recently died. After merging Ace with several waste companies, Buntrock founded Waste Management in 1968.\(^\text{83}\) Under Buntrock’s reign as its CEO, the company went public in 1971 and expanded during the 1970s and 1980s though several acquisitions of local waste hauling companies and landfill operators. At one point, the company was performing close to 200 acquisitions a year.\(^\text{84}\)

\(^{82}\) SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).


\(^{84}\) SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).
From 1971 to 1991, Waste Management enjoyed 36 percent average annual revenue growth and 36 percent average annual net income growth. By 1991, it had become the largest waste removal business in the world, with revenue of more than $7.5 billion.\(^\text{85}\) Despite a recession, Buntrock and other executives at Waste Management continued to set aggressive goals for growth. For example, in 1992, the company forecasted that revenue and net income would increase by 26.1 percent and 16.5 percent, respectively, over 1991’s figures.\(^\text{86}\)

**Waste Management’s Core Operations**

Waste Management’s core solid waste management operations in North America consisted of the following major processes: collection, transfer, and disposal.

**Collection**

Solid waste collection to commercial and industrial customers were generally performed under one-to three-year service agreements. Most of its residential solid waste collection services were performed under contracts with—or franchises granted by—municipalities giving it exclusive rights to service all or a portion of the homes in their respective jurisdictions. These contracts or franchises usually ranged in duration from one to five years. Factors that contributed to the determination for fees collected from industrial and commercial customers were market conditions, collection frequency, type of equipment furnished, length of service agreement, type and volume or weight of the waste collected, distance to the disposal facility, and cost of disposal. Similar factors determined the fees collected in the residential market.\(^\text{87}\)

**Transfer**

As of 1995, Waste Management operated 151 solid waste transfer stations, facilities where solid waste was received from collection vehicles, and was then transferred to trailers for transportation to disposal facilities. In most instances, several collection companies used the services of these facilities, which were provided to municipalities or

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\(^\text{85}\) SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).

\(^\text{86}\) SEC s. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).

\(^\text{87}\) Waste Management, 1995 10-K.
counties. Market factors, the type and volume or weight of the waste transferred, the extent of processing of recyclable materials, the transport distance involved, and the cost of disposal were the major factors that contributed to the determination of fees collected. 88

**Disposal**

As of 1995, Waste Management operated 133 solid waste sanitary landfill facilities, 103 of which were owned by the company. All of the sanitary landfill facilities were subject to governmental regulation aimed at limiting the possibility of water pollution. In addition to governmental regulation, land scarcity and local resident opposition also conspired to make it difficult to obtain permission to operate and expand landfill facilities in certain areas. The development of a new facility also required significant up-front capital investment and a lengthy amount of time, with the added risk that the necessary permit might not be ultimately issued by the municipality or county. In 1993, 1994, and 1995, approximately 52 percent, 55 percent, and 57 percent, respectively, of the solid waste collected by Waste Management was disposed of in sanitary landfill facilities operated by it. These facilities were typically also used by other companies and government agencies on a noncontract basis for fees determined by market factors and the type and volume or weight of the waste. 89

**Corporate Expansion**

As the company grew, it expanded its international operations and into new industries, including hazardous waste management, waste-to-energy, and environmental engineering businesses. By the mid-1990s, Waste Management had five major business groups that provided the following services: solid waste management, hazardous waste management, engineering and industrial services, trash-to-energy, water treatment and air quality services, and international waste management. Table 2.2.1, on pages 36 and 37, describes the primary services these groups provided and revenues recorded in 1993, 1994, and 1995.

**Challenges**

By the mid-1990s, the company’s core North American solid waste business was suffering from intense competition and excess landfill capacity in some of its markets. New environmental regulations also added to the cost of

88 1995 10-K.

89 1995 10-K.
operating a landfill and made it more difficult and expensive for Waste Management to obtain permits for constructing new landfills or to expand old ones.\textsuperscript{90}

Several of its other businesses (including its hazardous waste management business and several international operations) were also performing poorly. After a strategic review that began in 1994, the company was reorganized into four global lines of business: waste services, clean energy, clean water, and environmental and infrastructure engineering and consulting.\textsuperscript{91}

\textsuperscript{90} SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).

\textsuperscript{91} 1995 10-K.
### TABLE 2.2.1 Waste Management’s Major Business Groups

<table>
<thead>
<tr>
<th>Business Group</th>
<th>Services</th>
<th>Revenues ($000)</th>
<th>1993</th>
<th>1994</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>Solid waste management</td>
<td>Garbage collection, transfer, resource recovery, and disposal for commercial, industrial, municipal, and residential customers, as well as to other waste management companies. Included recycling of paper, glass, plastic and metal, removal of methane gas from sanitary landfill facilities for use in electricity generation, and medical and infectious waste management services to hospitals and other health care and related facilities.</td>
<td></td>
<td>4,702,166</td>
<td>5,117,871</td>
<td>5,642,857</td>
</tr>
<tr>
<td>Hazardous waste management</td>
<td>Chemical waste treatment, storage, disposal, and related services provided commercial and industrial customers, governmental entities, and other waste management companies by Waste Management and Chemical Waste Management (CWM), a wholly owned subsidiary; onsite integrated hazardous waste management services provided by Advanced Environmental Technical Services (AETS), a 60 percent-owned subsidiary; and low-level radioactive waste disposal services provided by subsidiary Chem-Nuclear Systems.</td>
<td></td>
<td>661,860</td>
<td>649,581</td>
<td>613,883</td>
</tr>
<tr>
<td>Engineering and industrial</td>
<td>Through Rust International, a 60 percent-owned subsidiary provides environmental and infrastructure engineering and consulting services, primarily to clients in government and in the chemical, petrochemical, nuclear, energy, utility, pulp and</td>
<td></td>
<td>1,035,004</td>
<td>1,140,294</td>
<td>1,027,430</td>
</tr>
</tbody>
</table>
paper, manufacturing, environmental services, and other industries.

Trash-to-energy, water treatment, air quality

Through Wheelabrator Technologies Inc. (WTI), a 58 percent-owned subsidiary, develops, arranges financing for, operates, and owns facilities that dispose of trash and other waste materials by recycling them into electrical or steam energy. Also designs, fabricates, and installs technologically advanced air pollution control, and systems and equipment. WTI’s clean water group is principally involved in design, manufacture, operation, and ownership of facilities and systems used to purify water, to treat municipal and industrial wastewater, and to recycle organic wastes into compost material useable for horticultural and agricultural purposes.

International waste management

Solid and hazardous waste management and related environmental services in ten countries in Europe and in Argentina, Australia, Brazil, Brunei, Hong Kong, Indonesia, Israel, Malaysia, New Zealand, Taiwan, and Thailand. Also has 20 percent interest in Wessex Water Plc, an English publicly traded company providing water treatment, water distribution, wastewater treatment, and sewerage services.

Consolidated Revenue*

<table>
<thead>
<tr>
<th></th>
<th>1993</th>
<th>1994</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>8,636,116</td>
<td>9,554,705</td>
<td>10,274,617</td>
</tr>
</tbody>
</table>

*Intercompany revenue eliminations in 1993, 1994, and 1995, respectively, were as follows: $(316,344), ($388,470), ($353,309).
**Case Questions**

1. Based on your understanding of inherent risk assessment and the case information, please identify three specific factors about Waste Management that might cause you to elevate inherent risk. When identifying each factor, indicate the financial statement account that is likely to be most affected (and briefly discuss why it is most affected).

2. Consult Paragraphs #71–72 of PCAOB Auditing Standard No. 2. Next, identify the types of revenue earned (a brief description will do) by Waste Management. Do you believe that any of the different types of revenue earned by Waste Management would have a “different level” of inherent risk? Why or why not?

3. Please consult Q39 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of the different types of revenue earned (in Question #2) would influence the nature, timing, and extent of your audit work at Waste Management.

4. Please consult Paragraphs #24–25 of PCAOB Auditing Standard No. 2. For one of Waste Management’s revenue sources (choose one), please brainstorm about how a fraud might occur. Next, identify an internal control procedure that would prevent, detect, or deter such a fraudulent scheme?
Case 2.3

WorldCom: A Focus on Fraud and Inherent Risk Assessment

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.

Growth through Acquisitions

WorldCom evolved from a long-distance telephone provider named Long Distance Discount Services (LDDS), which had annual revenues of approximately $1.5 billion by the end of 1993. LDDS connected calls between the local telephone company of a caller and the local telephone company of the call’s recipient by reselling long distance capacity it purchased from major long distance carriers (e.g., AT&T, MCI, and Sprint) on a wholesale basis. LDDS was renamed WorldCom in 1995.

A change in industry regulation was the primary catalyst for WorldCom’s growth. That is, the Telecommunications Act of 1996 allowed long-distance telephone service providers to enter the market for local telephone services and other telecommunications services, such as Internet related services. Like many players in the industry, WorldCom turned to acquisitions to expand into these markets.

WorldCom’s revenues grew rapidly as it embarked on these acquisitions. Between the first quarter of 1994 and the third quarter of 1999, WorldCom’s year-over-year revenue growth was over 50 percent in 16 of the 23 quarters;  

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92 Ibid., 44–45.
the growth rate was less than 20 percent in only 3 of the quarters. WorldCom’s stock price experienced rapid growth as well, from $8.17 at the beginning of January 1994 to $47.91 at the end of September 1999 (adjusted for stock splits). Importantly, its stock performance exceeded those of its largest industry competitors, AT&T, and Sprint.93

**MFS and Subsidiary UUNET**

In late 1996, WorldCom acquired MFS, which provided local telephone services, for $12.4 billion. In that transaction, WorldCom also gained an important part of the Internet backbone through MFS’s recently acquired subsidiary, UUNET.94

**Brooks Fiber Properties, CompuServe Corporation, and ANS Communications**

In 1998, WorldCom purchased Brooks Fiber Properties for approximately $2.0 billion and CompuServe Corporation and ANS Communications (a three-way transaction valued at approximately $1.4 billion that included a five-year service commitment to America Online). Each of these companies expanded WorldCom’s presence in the Internet arena.

**MCI**

In September 1998, WorldCom acquired MCI, using approximately 1.13 billion of its common shares and $7.0 billion cash as consideration, for a total price approaching $40 billion. MCI’s annual revenues of $19.7 billion in 1997 far exceeded WorldCom’s 1997 annual revenues of $7.4 billion. As a result of this merger, WorldCom became the second-largest telecommunications provider in the United States.

**SkyTel Communications and Sprint**

In October 1999, WorldCom purchased SkyTel Communications, adding wireless communications to its service offerings, for $1.8 billion. A few days after its SkyTel acquisition, WorldCom announced that it would merge with Sprint in a deal valued at $115 billion. In the proposed deal, WorldCom would gain Sprint’s PCS wireless business, in addition to its long distance and local calling operations.95

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93 Ibid., 48.

94 Ibid., 46.

95 Ibid., 47–48.
Challenges

By 2000, WorldCom started to face some difficult challenges. For starters, WorldCom faced fierce competition in its industry. In addition, WorldCom’s proposed merger with Sprint failed to receive approval from the Antitrust Division of the United States Department of Justice. As a result, the companies officially terminated their merger discussions on July 13, 2000.6

Although WorldCom’s revenue continued to grow, its rate of growth slowed. On November 1, 2000, WorldCom announced the formation of two tracking stocks: one—called WorldCom Group—to capture the growth of its data business, and the other—called MCI—to capture the cash generation of its voice business, which experienced a lower growth rate. WorldCom also announced reduced expectations for revenue growth of the consolidated company, from its previous expectation of 12 percent to between 7 percent and 9 percent in the fourth quarter of 2000 and all of 2001. By the close of market on the day of its announcement, WorldCom’s stock price had fallen by 20.3 percent, from $23.75 on October 31, 2000, to $18.94.7

Industry conditions worsened in 2001. Both the local telephone services and Internet segments experienced downturns in demand. The impact of the downturn in the Internet segment was particularly severe because of the industry’s increased investment in network capacity (supply). Many competitors found themselves mired in long-term contracts that they had entered into to obtain the capacity to meet anticipated customer demand. As the ratio of their expenses to revenues was increasing, industry revenues and stock prices plummeted. For example, the stock prices of WorldCom, AT&T, and Sprint each lost at least 75 percent of its share price value between January 2000 and June 25, 2002.8

Case Questions

1. Based on your understanding of inherent risk assessment and the case information, please identify three specific factors about WorldCom’s strategy within its industry that might cause you to elevate inherent risk.

2. Please consult Q39 and Q43 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how

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6 Ibid., 48–49.

7 Ibid., 50.

8 Ibid., 51–55.
your understanding of the inherent risks identified at WorldCom (in Question #1) would influence the nature, timing, and extent of your audit work at WorldCom.

3. Please consult Paragraphs B1 and B6 in Appendix B of the Internal Control Standard. If you were conducting an internal control audit of WorldCom, comment about how WorldCom’s acquisition strategy would impact the nature, timing, and extent of your audit work at WorldCom.

4. Based on your understanding of fraud risk assessment, what are the three conditions that are likely to be present when a fraud occurs? Based on the information provided in the case, which of these three conditions appears to be most prevalent, and why?
Case 2.4

Sunbeam: A Focus on Fraud and Inherent Risk Assessment

Synopsis

In April 1996, Sunbeam named Albert J. Dunlap as its CEO and Chairman. Formerly with Scott Paper Co., Dunlap was known as a turnaround specialist and was even nicknamed “Chainsaw Al” because of the cost-cutting measures he typically employed. Almost immediately, Dunlap began replacing nearly all of the upper management team and led the company into an aggressive corporate restructuring that included the elimination of half of its 12,000 employees and the elimination of 87 percent of Sunbeam’s products.

Unfortunately, in May 1998, Sunbeam disappointed investors with its announcement that it had earned a worse-than-expected loss of $44.6 million in the first quarter of 1998.89 CEO and Chairman Dunlap was fired in June 1998. In October 1998, Sunbeam announced that it would need to restate its financial statements for 1996, 1997 and 1998.100

Sunbeam’s History101

The early beginnings of Sunbeam Corporation can be traced back to the Chicago Flexible Shaft Company, founded by John Stewart and Thomas Clark in 1897. Although the company did not change its name to Sunbeam until 1946, it adopted the name Sunbeam in its advertising shortly after it expanded into manufacturing electrical appliances in 1910.

Successful products in the 1930s included the Sunbeam Mixmaster, a stationary food mixer; the Sunbeam Shavemaster Shaver, the first automatic coffeemaker; and the first pop-up electric toaster. Later appliances included


100 Much of this section is based on information from GAO-03-138, Appendix XVII “Sunbeam Corporation,” 201.

101 Hoovers Online.
the hair dryer (1949), humidifiers (1950), ice crushers (1950), a knife sharpener (1950), the Sunbeam Egg Cooker (1950), the Sunbeam Controlled Heat fry pan (1953), and the electric blanket (1955). The company acquired rival household appliance maker Oster in 1960.

In 1981, Sunbeam was acquired by industrial conglomerate Allegheny International, which fell into bankruptcy in 1988 due to economic difficulties in its other divisions. Michael Price, Michael Steinhardt, and Paul Kazarian bought Allegheny from its creditors in 1990 and named the company Sunbeam-Oster. Kazarian assumed the positions of CEO and Chairman. Under his leadership, the company paid off its debt, reorganized operations, and cut its workforce dramatically.102

The company went public in 1992. Mr. Kazarian was forced out in 1993 and replaced by Roger Schipke, a former manager of General Electric’s appliance division. Kazarian was subsequently awarded $160 million in a lawsuit he filed for being forced out. The company was renamed Sunbeam in 1995. That year, the company faced stagnant product prices and other difficult industry conditions, such as the growth of discount chains. In the face of these conditions, Sunbeam introduced new product lines, made acquisitions, and invested in greater production capacity.103 After several quarters of disappointing sales and earnings results, Schipke tendered his resignation in April 1996. The company named Albert J. Dunlap, chief of Scott Paper Co., as Schipke’s successor.

**Sunbeam in 1996**

Sunbeam Corporation had five major product lines in its domestic operations: household appliances, health care products, personal care and comfort products, outdoor cooking products, and “away from home” business. It also had international sales that accounted for approximately 19 percent of its total net sales.104

Household appliances (29 percent of 1996 domestic net sales) included blenders, food steamers, bread makers, rice cookers, coffee makers, toasters, and irons. Examples of health care products (11 percent) were vaporizers,

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103 Ibid.

104 1996 10K filing to SEC, Item 1 (“Business”).
humidifiers, air cleaners, massagers, and blood pressure monitors. Its line of personal care and comfort products (21 percent) included shower massagers, hair clipper and trimmers, and electric warming blankets. Some of its major outdoor cooking products (29 percent) were electric, gas, and charcoal grills, and grill accessories. Its “away from home” business (5 percent) marketed clippers and related products for the professional and veterinarian trade as well as products to commercial and institutional channels.

Executive Leadership

Chairman and CEO Albert J. Dunlap assumed leadership in 1996 and promptly invested $3 million of his own money in Sunbeam shares. “If I make a lot of money here [at Sunbeam]—which I certainly intend to do—then the shareholders will make a lot…. I’m in lockstep with the shareholders.”

Dunlap immediately hired Russell Kersh as Sunbeam’s chief financial officer. Dunlap and Kersh both entered into lucrative three-year employment agreements that gave them strong financial incentives to raise the share price of the company. Dunlap then replaced almost all of top management, and their replacements were each provided with strong financial incentives to improve the company’s share price.

Corporate Restructuring and Plans for Growth

Under Dunlap’s reign, Sunbeam embarked on an aggressive restructuring that would involve the elimination of half of the company’s 12,000 employees; the sale or consolidation of 39 of its 53 facilities; the divestiture of several lines of businesses, such as its furniture business, the elimination of 87 percent of Sunbeam’s product list; and the replacement of six regional headquarters in favor of a single office in Delray Beach, Florida. “We planned this like the invasion of Normandy…. We attacked every aspect of the business, said Dunlap.”


Dunlap publicly predicted that, as a result of the restructuring, the company would attain operating margins of 20 percent of sales in 1997, and increase its sales by 20 percent, 30 percent, and 35 percent respectively in 1997, 1998, and 1999. This meant that the company would have to double its sales to $2 billion by 1999. Other goals were to introduce 30 new products each year domestically, and to triple international sales to $600 million by 1999.

**Times of Trouble**

After the first quarter of 1997, Dunlap heralded the success of the company’s turnaround efforts:

> The impressive growth in both revenues and earnings is proof that the revitalization of Sunbeam is working. In fact, the sales growth in the first quarter is the highest level achieved without acquisitions since Sunbeam became public in 1992.... The substantially higher earnings in the quarter from ongoing operations were due to increased sales coupled with the successful implementation of our restructuring efforts.

Yet, by the fourth quarter of 1997, Sunbeam’s results had fallen below expectations. Its first quarter results in 1998 earned a worse-than-expected loss of $44.6 million. CEO and Chairman Dunlap was fired in June 1998. In October 1998, Sunbeam announced that the audit committee of its Board of Directors had determined that the company would need to restate its prior financial statements, as follows: to reduce the 1996 net loss by $20 million (9 percent of reported losses); to reduce 1997 net income by $71 million (65 percent of reported earnings); and to

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increase 1998 earnings by $10 million (21 percent of reported losses).\textsuperscript{112}

Sunbeam filed for Chapter 11 bankruptcy protection in February 2001. In May 2001, the U.S. Securities and Exchange Commission (SEC) brought charges of fraud against several former Sunbeam officials. At the end of 2002, the company emerged from Chapter 11 and changed its name to American Household. In early 2005, it was acquired by Jarden to be part of its consumer solutions division.

**Case Questions**

1. Based on your understanding of fraud risk assessment, what are the three conditions that are likely to be present when a fraud occurs? Based on your understanding of the Sunbeam audit, which of these three conditions appears to be most prevalent, and why?

2. Consult Paragraph #39 of PCAOB Auditing Standard No. 2. Based on your understanding of inherent risk assessment and the case information, please identify three specific factors about Sunbeam that might cause you to elevate inherent risk.

3. Please consult Q39 and Q43 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of the inherent risks identified at Sunbeam (in Question #2) would influence the nature, timing, and extent of your audit work at Sunbeam.

4. Consult Paragraphs #71–72 of the PCAOB Auditing Standard No. 2. First, explain what is meant by “classes of transactions.” Next, based on the case information, list the different classes of transactions for the revenue account. Finally, do you believe that the different classes of transactions have differing levels of inherent risk? Why or why not?

5. Paragraph #25 of PCAOB Auditing Standard No. 2 requires management to design and implement controls to prevent, deter, and detect fraud. In addition, the standard requires the auditor to evaluate such controls (Paragraph #24). For one of Sunbeam’s classes of revenue transactions (choose one), please brainstorm about how a revenue recognition fraud might occur. Next, can you think of an internal control procedure that would prevent, detect, or deter such a fraudulent scheme?

\textsuperscript{112} GAO-03-138, Appendix XVII “Sunbeam Corporation,” 201.
Case 2.5

Qwest: A Focus on Fraud and Inherent Risk Assessment

Synopsis

When Joseph Nacchio became Qwest’s CEO in January 1997, its existing strategy to construct a state-of-the art fiber-optic network across major cities in the United States began to shift toward communications services as well. By the time it released earnings in 1998, Nacchio proclaimed Qwest’s successful transition from a network construction company to a communications services provider. “We successfully transitioned Qwest … into a leading Internet protocol-based multimedia company focused on the convergence of data, video, and voice services.”

During 1999 and 2000, Qwest consistently met its aggressive revenue targets and became a darling to its investors. Yet, it was later uncovered that Qwest had fraudulently recognized $3.8 billion in revenues and fraudulently excluded $231 million in expenses. When the company announced its intention to restate revenues, its stock price plunged to a low of $1.11 per share in August 2002, from a high of $55 per share in July 2000. During this period, its market capitalization declined by 98 percent, from a high of $91 billion to a low of $1.9 billion.

Strategic Direction

In the mid-1990s, Qwest Communications International embarked on building a fiber-optic network across major cities within the United States. The network would consist of a series of cables that contained strands of pure glass that could transmit data by using light and the appropriate equipment. Qwest’s initial strategy was to build the network of fiber cable and sell it in the form of an Indefeasible Right of Use (IRU), an irrevocable right to use a specific amount of fiber for a specified time period.

However, when Joseph Nacchio became Qwest’s CEO in January 1997, the strategy of the company shifted toward communications services. Nacchio envisioned that Qwest had the potential of becoming a major


114 SEC v. Qwest, 1–2.
telecommunications company that offered Internet and multimedia services over its fiber-optic network, in addition to offering traditional voice communications services as well.\textsuperscript{115}

**Qwest’s Construction Services Business**

A fiber-optic network consisted of a series of cables that contained strands of pure glass and allowed the transmission of data between any two connected points by using beams of light. While each cable of the fiber optic network typically contained at least 96 strands of fiber, Qwest intended to use 48 of the fiber strands for its own use and to sell the remaining strands to help finance the cost of construction of the network.\textsuperscript{116} Total revenue from its construction services business was approximately $224.5 million, $688.4 million, and $581.4 million in 1999, 1998, and 1997, respectively.\textsuperscript{117}

**Competition**

As of 1999, Qwest faced competition in the construction services segment from three other principal facilities-based long-distance fiber-optic networks: AT&T, Sprint, and MCI WorldCom. In its 1999 annual filing with the SEC, Qwest warned investors that others—including Global Crossing, GTE, Broadwing, and Williams Communications—were building or planning networks that could employ advanced technology similar to Qwest’s network. Yet, Qwest assured investors that it was at a significant advantage because its network would be completed in mid-1999, at least a year ahead of the planned completion of other networks, and it could extend and expand the capacity on its network using the additional fibers that it had retained.\textsuperscript{118}

**Qwest’s Communications Services Business**

As part of its communications services business, Qwest provided traditional voice communications services, as well as Internet and multimedia services to business customers, governmental agencies, and consumers in domestic and international markets. Qwest also provided wholesale services to other communications providers, including Internet


\textsuperscript{116} 1997 10-K, 10.

\textsuperscript{117} 1999 10-K, 12.

\textsuperscript{118} 1999 10-K, 13.
service providers (ISPs) and other data service companies. Total revenue from its communications services business was approximately $3,703.1 million, $1,554.3 million, and $115.3 million in 1999, 1998, and 1997, respectively.\(^{119}\)

**Regulation**

The impact of regulatory change was significant in the highly regulated telecommunications industry. The Telecommunications Act of 1996 increased competition in the long distance market by allowing the entry of local exchange carriers and others. Indeed, Qwest warned investors in its 1999 annual filing with the SEC that its costs of providing long distance services could be affected by changes in the rules controlling the form and amount of “access charges” long distance carriers had to pay local exchange carriers to use the local networks they needed to provide the local portion of long distance calls.\(^{120}\)

**Competition**

Qwest’s primary competitors in its communications services business included AT&T, Sprint, and MCI WorldCom, all of whom had extensive experience in the traditional long distance market. In addition, the industry faced continuing consolidation, such as the merger of MCI and WorldCom.

In the markets for Internet and multimedia services, Qwest competed with a wide range of companies that provided web hosting, Internet access, and other Internet Protocol (IP) products and services. Significant competitors included GTE, UUNET (a subsidiary of MCI WorldCom), Digex, AboveNet, Intel, and Exodus.\(^{121}\)

**Qwest’s Mergers and Acquisitions**

Like its competition, Qwest pursued several mergers and acquisitions to strengthen its service offerings. From October 1997 to December 1998, it acquired, SuperNet, Inc., a regional ISP in the Rocky Mountain region; in March 1998, it acquired Phoenix Network, Inc., a reseller of long distance services; in April 1998, it acquired EUnet International Limited, a leading European ISP; in June 1998, it purchased LCI International, Inc., a provider of long distance telephone services; and in December 1998, it acquired Icon CMT Corp., a leading Internet solutions

\(^{119}\) 1999 10-K, 10.

\(^{120}\) 1999 10-K, 14–17.

\(^{121}\) 1999 10-K, 13.
In many of these acquisitions, Qwest used its own company stock as the tender that was needed to acquire the companies.

Qwest’s string of acquisitions culminated during 1999 when it entered into a merger agreement with telecommunications company US West on July 18, 1999. The merger agreement required Qwest to issue $69 worth of its common stock for each share of US West stock, and it gave US West the option to terminate the agreement if the average price of Qwest stock was below $22 per share or the closing price was below $22 per share for 20 consecutive trading days. Less than a month after the merger announcement, Qwest’s stock price had dropped from $34 to $26 per share.

Case Questions

1. Based on your understanding of fraud risk assessment, what three conditions are likely to be present when a fraud occurs? Based on your understanding of the Qwest audit, which of these three conditions appears to be most prevalent and why?

2. Consult Paragraph #39 of PCAOB Auditing Standard No. 2. Based on your understanding of inherent risk assessment and the case information, please identify three specific factors about Qwest’s business model that might cause you to elevate inherent risk if you were conducting an audit of internal control over financial reporting at Qwest.

3. Consult Q39 and Q43 of the PCAOB Staff Questions & Answers (May 16, 2005). Please comment about how your understanding of the inherent risks identified at Qwest (in Question 2) would influence the nature, timing, and extent of your audit work at Qwest.

4. Please consult Paragraphs #71–72 of PCAOB Auditing Standard No. 2. Next, consider revenue earned in the construction services and the communication services businesses. Do you believe that any of the different types of revenue earned by Qwest would have a “different level” of inherent risk? Why or why not?

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Case 2.6

The Baptist Foundation of Arizona: A Focus on Fraud and Inherent Risk Assessment

Synopsis

The Baptist Foundation of Arizona (BFA) was organized as an Arizona non-profit organization primarily to help provide financial support for various Southern Baptist causes. Under William Crotts’s leadership, the foundation engaged in a major strategic shift in its operations. BFA began to invest heavily in the Arizona real estate market, and also accelerated its efforts to sell investment agreements and mortgage-backed securities to church members.

Two of BFA’s most significant affiliates were ALO and New Church Ventures. It was later revealed that BFA had set up these affiliates to facilitate the “sale” of its real estate investments at prices significantly above fair market value. In so doing, BFA’s management perpetrated a fraudulent scheme that cost at least 13,000 investors more than $590 million. In fact, Arizona Attorney General Janet Napolitano called the BFA collapse the largest bankruptcy of a religious nonprofit in the history of the United States.123

Background

The Baptist Foundation of Arizona (BFA) was an Arizona religious nonprofit 501(c)(3) organization that was incorporated in 1948 to provide financial support for Southern Baptist causes. It was formed under the direction of the Arizona Southern Baptist Convention, which required BFA to be a profitable, self-sustaining independent entity (i.e., it could not accept money from any other source.) In BFA’s early days, it focused its attention on funding church start-ups and providing aid for children and the elderly. In 1962, Pastor Glen Crotts became its first full-time president and was subsequently succeeded in 1984 by his son, William P. Crotts.

Under William Crotts’s leadership, the foundation engaged in a major strategic shift in its operations. BFA began to invest heavily in the Arizona real estate market, and also accelerated its efforts to sell investment agreements and mortgage-backed securities to church members. Although Arizona real estate prices skyrocketed in

the early 1980s, the upward trend did not continue, and property values declined substantially in 1989. Soon after the decline, management decided to establish a number of related affiliates. These affiliates were controlled by individuals with close ties to BFA, such as former board members. In addition, BFA gained approval to operate a trust department that would serve as a nonbank passive trustee for individual retirement accounts (IRAs). In order to do so, BFA had to meet certain regulatory requirements, which included minimum net worth guidelines.

**Related Parties**

Two of BFA’s most significant affiliates were ALO and New Church Ventures. A former BFA director incorporated both of these nonprofit entities. The entities had no employees of their own, and both organizations paid BFA substantial management fees to provide accounting, marketing, and administrative services. As a result, both ALO and New Church Ventures owed BFA significant amounts by the end of 1995. On an overall basis, BFA, New Church Ventures, and ALO had a combined negative net worth of $83.2 million at year-end 1995, $102.3 million at year-end 1996, and $124.0 million at year-end 1997.124

**New Church Ventures**

Although the stated purpose of New Church Ventures was to finance new Southern Baptist churches in Arizona, its major investment activities were similar to those of BFA. That is, New Church Ventures raised most of its funds through the sale of investment agreements and mortgage-backed securities, and then invested most of those funds in real estate loans to ALO. Thus, the majority of New Church Ventures’s assets were receivables from ALO. New Church Ventures’s two main sources of funding were BFA’s marketing of its investment products to IRA investors and loans it received from BFA.125

**ALO**

Contrary to its intended purpose to invest and develop real estate, one of ALO’s primary activities in the 1990s was to buy and hold BFA’s nonproducing and over-valued investments in real estate, so BFA could avoid recording losses (write-downs) on its real estate. In fact, ALO was the owner of many of the real estate investments that were utilized as collateral for IRA investor loans. However, BFA’s 1991 through 1997 financial statements did not include a set of summarized financial statements for ALO. ALO incurred operating losses each year since its


125 Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 8–9.
inception in 1988. By the end of 1997, ALO’s total liabilities of $275.6 million were over two times its assets, leaving a negative net worth of $138.9 million. In total, ALO owed New Church Ventures $173.6 million and BFA $70.3 million, respectively.\textsuperscript{126}

**BFA’s Religious Exemptions**

BFA operated in a manner similar to a bank in many respects. Its investment products were similar to those sold by financial institutions. Its trust department, which was fully authorized by the federal government to serve as a passive trustee of IRAs, was similar to a trust department at a bank. BFA also made real estate loans in a manner similar to a bank. Because of its bank-like operations and products, BFA faced several risk factors that affect banks and other savings institutions, such as interest-rate risk and liquidity risk.\textsuperscript{127}

Yet, because of its status as a religious organization, BFA’s product offerings were not subject to the same regulatory scrutiny as a bank’s products.\textsuperscript{128} That is, although BFA underwrote its own securities offerings and used its staff to sell the investment instruments (like a bank), it was able to claim a religious exemption from Arizona statutes that regulate such activities. BFA also claimed exemption from Arizona banking regulations on the basis that its investment products did not constitute deposits as defined by Arizona banking laws.\textsuperscript{129}

**Passive Trustee Operation**

BFA gained approval to operate a trust department that would serve as a nonbank passive trustee for IRAs. To operate a trust department, BFA had to comply with certain regulatory requirements, such as maintaining an appropriate minimum net worth. In addition to the minimum net worth requirement, treasury regulations also required BFA to conduct its affairs as a fiduciary, that is, it could not manage or direct the investment of IRA funds. In addition, BFA had to subject itself to an audit that would detect any failures to meet these regulatory requirements. In cases where the minimum net worth was not achieved, treasury regulations prohibited a trustee from accepting new IRA accounts and required the relinquishment of existing accounts.\textsuperscript{130}

\textsuperscript{126} Ibid., 8–9.

\textsuperscript{127} Ibid., 4–5.

\textsuperscript{128} Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 5.

\textsuperscript{129} Ibid., 4–5.

\textsuperscript{130} Ibid., 15–20
Case Questions

1. Based on your understanding of inherent risk assessment, please identify three specific factors about BFA that might cause you to elevate inherent risk. Briefly provide your rationale for each factor that you identify.

2. Please comment on why the existence of related parties (such as ALO and New Church Ventures) present additional risks to an auditor. Do you believe that related party transactions deserve special attention from auditors? Why or why not?

3. Assume you are an investor in BFA. As an investor, what type of information would you be interested in reviewing before making an investment in BFA? Do you believe that BFA should have been exempt from Arizona banking laws? Why or why not?

4. Please consider the planning phase for the audit of BFA’s trust department operations. As an auditor, what type of evidence would you want to collect and examine in order to determine whether BFA was meeting the U.S. Treasury regulations for nonbank passive trustees of IRA accounts?
Case 2.7

The Fund of Funds: A Focus on Fraud and Inherent Risk

Assessment

Synopsis

As total assets reached $617 million in 1967, The Fund of Funds (FOF) was the most successful of the mutual funds offered by the Investor Overseas Services, Limited. In the late 1960s, FOF diversified into natural-resource asset investments. To do so, it formed a relationship with John King, a Denver oil, gas, and mineral investor and developer, whereby FOF would purchase oil and gas properties directly from his company, King Resources. By the 1970s, FOF was forced into bankruptcy.

It was later uncovered that King Resources had dramatically overcharged FOF for the properties that it sold to FOF. FOF’s bankruptcy trustee sued Arthur Andersen for failing to inform FOF that they were being defrauded by King Resources. Arthur Andersen was ultimately found liable and forced to pay around $70 million in civil damages, while John King was charged and convicted for masterminding the fraud against FOF.

Background

The Investors Overseas Services, Limited (IOS) was a Canadian company headquartered in Switzerland that offered diversified financial services, which included the management of mutual funds. IOS was founded in 1956 by Bernie Cornfield, a former Philadelphia social worker. One of IOS’s most successful mutual funds was its Fund of Funds (FOF). The FOF was also a Canadian company that had operations directed from Switzerland; however, its corporate records were maintained in Ferney-Voltaire, France. FOF’s total assets reached $617 million by the end of 1967.131

FOF incorporated FOF Proprietary Funds, Ltd. (FOF Prop) as an umbrella for specialized investment accounts that were managed by investment advisors. FOF Prop’s investments were heavily concentrated in American

securities. Each investment advisor had a duty to act in FOF’s best interests and to avoid a conflict of interest. In addition, each was compensated based on the realized and unrealized (paper) appreciation of their portfolios.132

Challenges Faced by IOS and Its Affiliates

During the mid- to late 1960s, IOS and its affiliates began to face several difficult conditions. The industry had become increasingly competitive as new funds entered the field. In addition, the entire industry was negatively impacted by a decline in stock market prices. The industry was also impacted by significant regulatory changes; that is, a number of national authorities had put more regulatory controls on fund selling.133

In 1966, the SEC brought charges that IOS had violated U.S. law by selling unregistered securities. As part of its settlement with the SEC, IOS and its affiliates, agreed to the following restrictions:134

• Will not engage in any activities subject to SEC jurisdiction.
• Will cease substantially all sales of securities to U.S. citizens or nationals, wherever located.
• Will not buy more than 3 percent of the stock of any registered investment company.
• Will dispose of its interests in Investors Planning Corp. of America, a registered broker-dealer, and Investors Continental Services, Ltd., a wholly owned Investors Overseas subsidiary and also a registered broker-dealer.
• Will withdraw the SEC broker-dealer registration of five investment companies owned by FOF.
• Will not acquire a controlling interest in any financial organization doing business in the United States.


FOF Expands into Natural Resource Assets\textsuperscript{135}

FOF’s strategy for dealing with the SEC sanctions and the prospect of a potential stock market downturn in the late 1960s was to diversify its holdings into assets less affected by the stock market, such as natural resource assets. So, to set up an investment account that specialized in natural resource assets, the officers of FOF contacted John King, a Denver oil, gas, and mineral investor and developer. In February 1968, a formal contract designating a subsidiary of King’s company, King Resources Corporation (KRC), as an investment advisor to FOF Prop was circulated between Edward Cowett, the chief operating officer (COO) of FOF, and Timothy Lowry, counsel for KRC. The agreement was not finalized and, ultimately, no written investment advisory agreement was ever entered into by the parties.

However, in a presentation at a meeting of the FOF Board of Directors in Acapulco, Mexico, on April 5, 1968, Mr. King suggested to the Board of FOF that they establish a proprietary account with an initial allocation of $10 million that should be invested in a minimum of 40 natural resource properties. In the presentation, King described the role of KRC as follows: “that of a vendor of properties to the proprietary account, with such properties to be sold on an arms-length basis at prices no less favorable to the proprietary account than the prices charged by KRC to its 200-odd industrial and other purchasers.” The Board approved the idea, and the National Resources Fund Account (NRFA) was established.

The clear intent of FOF was to use King’s expertise, as it did that of other account advisors, to locate and purchase speculative investments in oil, gas, and mineral assets. FOF had no means of valuing the assets proposed for investment and no means of participating in any work requirements. FOF’s dependence was encouraged by King in two ways: King’s own corporate documents represented that KRC was an investment advisor to FOF, and its prospect summaries barely outlined the geologic and financial information that would be necessary for an informed, independent investment decision.

Yet, investments in natural resource interests were different from other FOF Prop investments in one important aspect: the interest purchased in every natural resource transaction was a portion of an interest that was owned or had previously been owned by a member of the King group.

**KRC’s Pricing Policy**

As FOF’s COO, Cowett’s general understanding of the pricing policy was stated in a memorandum written on April 19, 1968: KRC would offer properties to FOF “from time to time and on a more or less continuous basis,” the terms of sale are to be “no less favorable than those offered by [KRC] to other non-affiliated purchasers [and] all transactions will be arms-length in nature.” Cowett also stated his understanding of the relationship and pricing policy in a letter dated November 11, 1970 (see Exhibit 2.7.1).

**Exhibit 2.7.1**

**Letter Written by Cowett on FOF’s Relationship with King Resources**

a. Without specific approval, no investment was to be made by the Fund in any resource property, unless KR or affiliated companies had a meaningful investment in the same properties …

b. KR was to have a 12-1/2 percent “net operating profits” interest in respect of any property acquired by the Fund …

c. The prices to be paid by the Fund were to be no higher than what would be paid by knowledgeable industry purchasers on a negotiated arms-length basis …

I understood that KR and affiliated companies would, of course, in setting a price to be paid by the Fund for a resource property, add to the direct cost of the property a reasonable amount to cover investigative and administrative costs incurred as a result of the property acquisition program.

I also understood that KR or affiliated companies might perform drilling, coring, or other services in connection with property exploration and development; I was specifically advised by John King and/or Rowland Boucher that amounts billed for such work would generally be calculated on a cost plus 7 percent or 8 percent profit basis.

I might add that in the last few months I have been advised by FOF personnel that in several instances properties were acquired by KR or affiliated companies one day and vended (either that same day or almost immediately thereafter) to the Fund at a 10 times or 20 times mark-up. Such a practice was clearly contrary to the understandings
motivating FOF to enter into and to continue the relationship with KR.

a. If KR could buy property at $x, this was a clear indication of the value of such property to knowledgeable industry purchasers.

b. If a tract of acreage was purchased by KR for $1 an acre, with a “turn-about” vending to the Prop Fund at a price of $10 an acre for 50 percent of the position, such transaction would fly directly in the face of the underlying concept of KR having a meaningful investment in properties along with FOF.…


Case Questions

1. Based on your understanding of inherent risk assessment, identify three specific factors about IOS and/or FOF that would be likely to impact your audit procedures if you were conducting an audit of IOS and/or FOF.

2. Please define what is meant by an “arm’s length” transaction. Given that all of FOF Prop’s investments in natural resources had also been owned (or were currently owned) by a member of the King group, do you believe that inherent risk related to these transactions should be elevated? Why or why not?

3. Consider the memo illustrated in Exhibit 2.7.1. If you were auditing FOF, would this memo impact your planned audit procedures? If so, what is the financial statement assertion that would cause you the greatest concern? Why?

4. If you were auditing one of the transactions between King Resources and FOF, what type of evidence would you seek to examine to determine whether the transaction was consummated on an “arm’s length” basis?
Section 3

Internal Control Systems

Audit firms are now required to express an opinion on the effectiveness of the internal control system over financial reporting for all publicly traded companies. In March 2004, the Public Company Accounting Oversight Board (PCAOB) issued Auditing Standard No. 2, “An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements” which provides the primary technical guidance to be followed by auditors in completing their internal control audits.

Due primarily to the excessive cost of completing the internal control audits in the first year, the PCAOB issued a series of staff questions and answers in May 2005 to help refine the approach being taken by auditors. Among other refinements, the guidance explicitly requires auditors to take a “top-down” approach in their internal control audits. To execute a “top-down” approach, an auditor must evaluate company level controls and other pervasive controls first, before considering internal control activities at the business process, application, or transaction level.

The cases in this section are designed to provide a mechanism to help illustrate the importance of company level controls and other pervasive controls to the effective design and operation of an internal control system.

The case readings have been developed solely as a basis for class discussion. The case readings are not intended to serve as a source of primary data or as an illustration of effective or ineffective auditing.

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Case 3.1

Enron: A Focus on Company Level Controls

Synopsis

In its 2000 Annual Report, Enron prided itself on having “metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business
approach and its innovative people.” Enron’s strategy seemed to pay off; in 2000, it was the seventh largest company on the Fortune 500, with assets of $65 billion and sales revenues of $100 billion. From 1996 to 2000, Enron’s revenues had increased by more than 750 percent and 65 percent per year, which was unprecedented in any industry. Yet, just a year later, Enron filed for bankruptcy, and billions of shareholder dollars and retirement savings were lost.

In 2002, Enron’s auditor Arthur Andersen LLP, one of the five largest international public accounting firms, was convicted of obstruction of justice in connection with shredding documents related to the Enron audit. And although this conviction was overturned in 2005 by the United States Supreme Court, Andersen’s decision to destroy evidence cast suspicion on whether Andersen was trying to cover up any guilt related to a failure to perform its professional responsibilities.

**Executive Incentives**

At Enron, executives had incentive to achieve high-revenue growth because their salary increases and cash bonus amounts were linked to reported revenues. In the proxy statement filed in 1997, Enron wrote that “base salaries are targeted at the median of a competitor group that includes peer group companies … and general industry companies similar in size to Enron.” In the proxy statement filed in 2001, Enron wrote, “The [Compensation] Committee determined the amount of the annual incentive award taking into consideration the competitive pay level for a CEO of a company with comparable revenue size, and competitive bonus levels for CEO’s in specific high performing

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companies.”

They also had incentive to achieve high revenues and earnings targets because of the shares of stock they held. That is, Enron made significant use of stock options as a further means of providing incentives for its executives to achieve growth. For example, Enron noted in its 2001 proxy statement that the following stock option awards would become exercisable as of February 15, 2001: 5,285,542 shares for Chairman Kenneth Lay, 824,038 shares for President Jeffrey Skilling, and 12,611,385 shares for all officers and directors combined. 141 In fact, as of December 31, 2000, Enron had dedicated 96 million of its outstanding shares (almost 13 percent of its common shares outstanding) to stock option plans. 142

**Enron’s Performance Review System**

Enron’s Performance Review Committee (PRC) determined the salaries and bonuses of employees on a semiannual basis. The PRC was initially instituted in the Gas Services business during the early 1990s after the merger between Houston Natural Gas and InterNorth. One Enron employee said, “At the time, it was a great tool … When we started the ranking process, we were trying to weed out the lower 5 or 6 percent of the company. We had some old dinosaurs, and we had some younger people who needed incentives.” 143 The PRC was gradually instituted company-wide when Jeffrey Skilling, a former McKinsey & Co. consultant who joined Enron in 1990 as the chief executive of the Enron Finance division, was promoted to president and COO.

The PRC made its determinations based on feedback reports that assessed the performance of employees on a

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scale from 1 to 5. Those who received ratings of 1’s received large bonuses, and a rating of 2 or 3 could cost a vice
president a six-figure sum. Those who ranked in the bottom 10 percent of the review had until the next semiannual
review to improve or they would be fired. Those in categories 2 and 3 were also given notice that they could be fired
within the next year.145

**Enron’s Changes to Accounting Procedures**

During the 1990s, Enron made significant changes to several of its accounting procedures designed to improve
reported earnings and financial position. For example, Enron began using mark-to-market (MTM) accounting for its
trading business, which allowed for the present value of the stream of *future* inflows and expenses under a contract to
be recognized as revenues and expenses, respectively, once the contract was signed. Enron was the first company
outside the financial services industry to use MTM accounting.146 Enron also began establishing several “special
purpose entities,” which were formed to accomplish specific tasks, such as building gas pipelines. If an SPE satisfies
certain conditions, it does not have to be consolidated with the financial statements of the sponsoring company.
Thus, an SPE could be utilized by a company hoping to achieve certain accounting purposes, such as hiding debt.

**Case Questions**

1. Based on your understanding of fraud risk assessment, what are the three conditions that are likely to be present
when a fraud occurs? Based on your understanding of the Enron audit, which of these three conditions appears
to be most prevalent and why?

2. Please consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Define what is meant by control
environment. Why does the control environment have a “pervasive” effect on the reliability of financial

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reporting at an audit client like Enron?

3. Please consult Q38 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of Enron’s control environment and other company level controls would help you implement a “top-down” approach to an internal control audit at Enron.

4. Consult Paragraphs #55–59 of PCAOB Auditing Standard No. 2 and Section 301 of SOX. What is the role of the audit committee in the financial reporting process? Do you believe that an audit committee can be effective in providing oversight of a management team like Enron’s?

5. Please consult Sections 302, 305, and Title IX of SOX. Do you believe that these new provisions could help to deter fraudulent financial reporting by an upper management group? Why or why not?
Case 3.2

Waste Management: A Focus on Company Level Controls

Synopsis

In February 1998, Waste Management announced that it was restating the financial statements it had issued for the years 1993 through 1996. In its restatement, Waste Management said that it had materially overstated its reported pretax earnings by $1.43 billion. After the announcement, the company’s stock dropped by more than 33 percent and shareholders lost over $6 billion.

The SEC brought charges against the company’s founder Dean Buntrock and five other former top officers. The charges alleged that management had made repeated changes to depreciation-related estimates to reduce expenses and had employed several improper accounting practices related to capitalization policies, also designed to reduce expenses.¹⁴⁷

Upper Management Turnover

In the summer of 1996, Dean Buntrock, who founded Waste Management in 1968, retired as CEO, but he continued to serve as chairman of the Board of Directors. Buntrock was initially replaced as CEO by Phillip Rooney, who had started working at Waste Management in 1969. By early 1997, Rooney resigned as director and CEO because of mounting shareholder discontent.

After a new five-month search, Waste Management chose Ronald LeMay, the president and COO of Sprint, to assume its post of chairman and CEO. Surprisingly, just three months into his new role, LeMay quit to return to his former job at Sprint.

In addition, several other key executives who, unlike LeMay, had worked for Waste Management for several years—including CFO James Koenig, Corporate Controller Thomas Hau, and Vice President of Finance Bruce Tobecksen—also resigned by the end of 1997.

¹⁴⁷ SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).
“Top-Side” Adjustments and Other Fraudulent Schemes

In February 1998, Waste Management announced it was restating the financial statements that it had previously issued for the years 1993 through 1996. While shareholders lost billions of dollars, management had already collected salaries and bonuses based on the inflated earnings and the resulting stock options. When the company’s improper accounting was revealed, the SEC described a fraudulent scheme that was perpetrated by several members of top management.

Specifically, the SEC brought charges against founder Buntrock and five other former top officers on charges of fraud. The SEC alleged that top management had made several “top-side” adjustments in the process of consolidating the results reported by each of their operating groups and intentionally hid these adjustments from the operating groups themselves. In addition, upper management had employed several other improper accounting practices designed to reduce expenses and artificially inflate earnings.¹⁴⁸

Specifically, to help conceal the intentional understatement of expenses, top management allegedly used a practice known as *netting*, whereby one-time gains realized on the sale or exchange of assets were used to eliminate unrelated current period operating expenses, as well as accounting misstatements that had accumulated from prior periods. In addition, it was also alleged that management made use of *geography* entries, which involved moving millions of dollars to different line items on the income statement. Essentially, these entries made it harder for auditors to compare operating results over time, a key audit procedure used by Arthur Andersen. Finally, top management allegedly made or authorized several false and misleading disclosures in financial statements.¹⁴⁹ The company’s auditor had proposed a series of action steps in early 1994 to help adjust their improper accounting. However, rather than following these steps, top management at Waste Management allegedly continued to manipulate their results in 1994, 1995, and 1996.

**Senior Executives Charged with Fraudulent Activity**

In March 1994, Executive Vice President and CFO James Koenig, who had worked as an auditor at Arthur Andersen

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¹⁴⁸ SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).

¹⁴⁹ Ibid.
before joining Waste Management in 1977, allegedly instructed a purchasing agent to draft a memo that concluded it supported one of the company’s salvage value estimates used to calculate depreciation expense. In fact, during November 1995, a study was initiated to determine the appropriate useful lives and salvage values of the company’s vehicles, equipment, and containers. Koenig allegedly ordered the study be stopped after a memo was released in 1996 which apparently suggested that the company’s salvage values should be reduced (which would have increased depreciation expense). Koenig also supposedly ordered the destruction of all copies of the memo and that the document be deleted from the author’s hard drive. The memo was never provided to the company’s auditors.

A complete profile of the accused senior executives is provided in Table 3.2.1. Top management profited from their fraudulent accounting, in at least two ways. First, through bonuses received that were based on the fraudulently inflated net income amounts. And second, through stock options which increased in value as the share price increased on the news of inflated net income amounts. In total, the SEC brought charges of fraud against six former top executives and calculated their ill-gotten gains, based on their bonuses, retirement benefits, trading, and charitable giving alone.
<table>
<thead>
<tr>
<th>Executive</th>
<th>Title</th>
<th>Profile</th>
<th>Alleged Ill-Gotten Gains</th>
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</thead>
<tbody>
<tr>
<td>Dean Buntrock</td>
<td>Founder, chairman of the Board of Directors, and CEO</td>
<td>Founded Waste Management in 1968. In June 1996, retired as CEO, but continued to serve as chairman of the Board of Directors. Also served as CEO on an interim basis from February of 1997 until July 1997 and continued to serve on the Board until his resignation on December 31, 1997.</td>
<td>$16,917,761</td>
</tr>
<tr>
<td>James Koenig</td>
<td>Executive vice president and CFO of Waste Management</td>
<td>Began employment with the company in July 1977. Like every CFO who preceded him, Koenig worked as an auditor at Arthur Andersen. In January 1997, Koenig was fired from the CFO position because of shareholder discontent, but he continued to have responsibility for financial, accounting, and reporting matters.</td>
<td>$951,005</td>
</tr>
<tr>
<td>Thomas Hau</td>
<td>Vice president, corporate controller, and CAO</td>
<td>Served as vice president, corporate controller and CAO from September 1990 to October 1997. Remained vice president until his</td>
<td>$640,100</td>
</tr>
</tbody>
</table>
Like every CAO that preceded him, Hau worked as an auditor at Arthur Andersen, where he was a partner for 30 years. While at AA, Hau was the partner in charge of the Waste Management audit from 1976 to 1983 and, later, he became head of the AA audit division that handled the Waste Management account. Hau was again slotted to become engagement partner for the Waste Management audit in 1990, but he resigned from AA after Buntrock invited him to join Waste Management.

Herbert Getz  
**Senior vice president, general counsel, and secretary**  
Began employment with the company in 1983, Getz retired from the Company in late 1998. Prior to coming to Waste Management, Getz was a lawyer at the firm that had served as outside counsel to Waste Management and its officers since 1968.  

Bruce Tobecksen  
**Vice president of finance**  
Vice president of finance until December of 1997, when he was asked to leave by the new CFO of Waste Management. Prior to holding that position, from 1987 to February 1993, Tobecksen was CFO of Chemical Waste Management, a subsidiary of Waste Management. Before joining Waste Management in 1979, Tobecksen worked as an audit manager at AA and, during a portion of that time, he worked on the Waste Management audit.
Case Questions

1. Three conditions are likely to be present when a fraud occurs. What are they? Based on your understanding of the Waste Management case, which of the three conditions appears to be most prevalent and why?

2. Briefly summarize what is meant by Paragraphs #76–78 of PCAOB Auditing Standard No. 2. Do you believe that the period-end financial reporting process deserves special attention from auditors? Why or why not?

3. Please consult Paragraphs #55–59 of PCAOB Auditing Standard No. 2 and Section 301 of SOX. What is the role of the audit committee in the financial reporting process? Do you believe that an audit committee can be effective in providing oversight of a management team such as that of Waste Management?

4. Consult Sections 302, 305, and Title IX of SOX. Do you believe that these new provisions will help to deter fraudulent financial reporting by a top management group such as that of Waste Management? Why or why not?
Case 3.3

Waste Management: A Focus on General Computing Controls

Synopsis

In February 1998, Waste Management announced that it was restating the financial statements it had issued for the years 1993 through 1996. In its restatement, it said that it had materially overstated its reported pretax earnings by $1.43 billion. After the announcement, the company’s stock dropped by more than 33 percent and shareholders lost over $6 billion.

The SEC brought charges against the company’s founder Dean Buntrock and five other former top officers. The charges alleged that management had made repeated changes to depreciation-related estimates to reduce expenses and had employed several improper accounting practices related to capitalization policies, also designed to reduce expenses.\(^{150}\)

Merger with USA Waste Service\(^{151}\)

Shortly after the announcement that Waste Management had overstated reported pretax earnings by $1.43 billion for the years 1993 through 1996, the company entered into a merger agreement with USA Waste Service, which was also in the business of collecting, transporting, and disposing of solid waste. The newly merged entity, named WMI, forecasted 1999 earnings per share in the range of $2.90 to $3.05, which took into account anticipated synergies as a result of the merger.

WMI’s Accounting and Billing Systems\(^{151a}\)

\(^{150}\) SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).

On July 29, 1998, less than two weeks after the merger closed, WMI reiterated the 1999 earnings forecast. WMI also introduced its senior management team on this date. Interestingly, although almost 80 percent of the regions and districts were staffed primarily by former Waste Management personnel, all of the senior managers at the corporate level were from USA Waste Service.

The success of the merger’s transition was highly dependent on the successful conversion of the accounting and billing systems of the operating entities that were part of Waste Management to the systems of USA Waste Service. The company completed tests of the accounting and billing systems conversions in the fall of 1998 and hoped to complete its full-scale conversion of these systems by the end of the first quarter of 1999.

Numerous Problems

In the early months of 1999, however, USA Waste Service experienced numerous problems with its newly consolidated accounting system. In particular, it did not provide the company’s field and corporate management with access to timely financial management information, which it needed to monitor the company’s operations. To address this issue, USA Waste Service developed an additional management information system to provide such financial reports. However, this system was not linked to the enterprise-wide general ledger system. As a result, a significant offline entry and reconciliation process had to be completed at each level of the company’s operations. Thus, the information in the enterprise-wide system was often incomplete or inaccurate, and it required extensive and time-consuming manual reconciliations. Meanwhile, the conversion of the old Waste Management operating entities’ billing system to the USA Waste Service system led to delayed and sometimes erroneous billing of customers.

So, to obtain an estimate of second quarter operating results, corporate financial personnel collected estimates from each of the five domestic operating areas. The results showed an estimated revenue shortfall from its target of more than $200 million and an earnings per share shortfall of $.11 for the second quarter of 1999. Throughout the month of June, management received additional information suggesting potential problems with second quarter results. Yet, in discussions with analysts and other members of the public at the 1999 Waste Expo conference from June 7 to 9, 1999, one of the largest waste industry trade meetings, WMI maintained its second quarter earnings guidance of $.78 to $.81 per share.

151a Ibid.
Following the June 9 Waste Expo, the company received a steady stream of adverse information. Therefore, WMI issued a press release on July 6, 1999, reporting a $250 million projected revenue shortfall from target levels and earnings per share forecasts in the range of $.67–$.70 for the second quarter of 1999 and $2.65–$2.70 for 1999. By the close of trading on July 7, the company’s share price had fallen from more than $53.50 per share to below $34 per share.

Following the July 6 announcement, the company’s Board of Directors appointed a three-member Executive Committee of independent members of the Board to oversee the management of the company. During July and August 1999, the Executive Committee and the Board requested and accepted the resignation of the company’s CFO, general counsel, COO, and CEO. The Board also ordered the creation of an updated and more effective financial system. After a detailed review of the company’s accounting records, the company recognized $1.23 billion in after-tax charges and adjustments to expenses.

Case Questions

1. What is the difference between an information technology general computing control and an application control? Provide an example of each in your response.

2. Please consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Based on the case information, how would you evaluate the control environment at WMI? Provide support for your evaluation.

3. Consult Paragraph #50 of PCAOB Auditing Standard No. 2. Do you believe that the information technology general controls have a pervasive effect on the reliability of financial reporting at an audit client like WMI? Why or why not? Please be specific.

4. Please consult Q5 of the PCAOB Staff Questions & Answers (June 23, 2004). Given the PCAOB’s position on M,D&A information, do you believe that the audit firm should be providing assurance on the information contained in public company press releases? Why or why not?
Case 3.4

The Baptist Foundation of Arizona: A Focus on Company Level Controls

Synopsis

The Baptist Foundation of Arizona (BFA), was organized as an Arizona non-profit organization primarily to help provide financial support for various Southern Baptist causes. Under William Crotts’s leadership, the foundation engaged in a major strategic shift in its operations. BFA began to invest heavily in the Arizona real estate market, and also accelerated its efforts to sell investment agreements and mortgage-backed securities to church members.

Two of BFA’s most significant affiliates were ALO and New Church Ventures. It was later revealed that BFA had set up these affiliates to facilitate the “sale” of its real estate investments at prices significantly above fair market value. In so doing, BFA’s management perpetrated a fraudulent scheme that cost at least 13,000 investors more than $590 million. In fact, Arizona Attorney General Janet Napolitano called the BFA collapse the largest bankruptcy of a religious nonprofit in the history of the United States.152

Background

Soon after the precipitous decline of Arizona’s real estate market in 1989, BFA management decided to establish a number of related affiliates. These affiliates were controlled by individuals with close ties to BFA, such as former board members. Two of BFA’s most significant affiliates were ALO and New Church Ventures. A former BFA director incorporated both of these nonprofit entities. The entities had no employees of their own, and both organizations paid BFA substantial management fees to provide accounting, marketing, and administrative services. As a result, both ALO and New Church Ventures owed BFA significant amounts by the end of 1995. On an overall basis, BFA, New Church Ventures, and ALO had a combined negative net worth (deficiency in assets) of $83.2 million at year-end 1995, $102.3 million at year-end 1996, and $124.0 million at year-end 1997.153


It was later revealed that BFA had sold real estate to both ALO and New Church Ventures at book value (or at a profit), even though the fair market value of the assets was, in actuality, significantly lower than the amounts recorded on BFA’s books. In addition, ALO had borrowed money from BFA and its related entities to provide the down-payment necessary to execute the purchase transactions with BFA. As a result, ALO’s debt increased each year from 1989 to 1997, and its deficit from operations also increased each year.

**BFA’s Independent Auditors**

From 1984 to 1998, BFA engaged Arthur Andersen as its independent auditor. Arthur Andersen was also hired by BFA or BFA’s attorneys to perform other accounting and auditing, management consulting, and tax services. From 1984 to 1997, Arthur Andersen issued unqualified audit opinions on BFA’s combined financial statements.

From 1992 to 1998, Jay Steven Ozer was the Arthur Andersen engagement partner with the ultimate responsibility for the conduct of the BFA audits, including the review of all audit work performed, resolution of all accounting issues, evaluating the results of all audit procedures, and signing the final audit opinions. Ann McGrath was an auditor on the BFA engagement from 1988 to 1998. In 1991, she began her role as manager on the audit engagements. For audit years 1991 to 1998, McGrath had primary responsibility for all audit planning and field work, which included assessing areas of inherent and control risk, supervising the audit team, and reviewing all of the audit workpapers.\(^{154}\)

**Employees’ Concerns over ALO’s Deficit**

In April 1996, several of BFA’s accountants and one attorney were sufficiently concerned about ALO’s deficit situation and related financial viability issues to confront BFA’s senior management team. The response was perceived as inadequate by the employees. And, due to their concerns about the lack of response by the BFA senior management team, most of them resigned during 1996, citing their concerns in their letters of resignation. One of BFA’s accountants who showed concern was Karen Paetz.

**Karen Paetz’s Concerns**

Karen Paetz was familiar with the financial condition of ALO and the interrelationships among ALO, New Church Ventures, and BFA because one of her responsibilities had been to supervise the preparation of the financial statements of New Church Ventures and ALO. In 1994, at the request of BFA President Crotts, Paetz produced a

\(^{154}\)Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 3–4.
detailed analysis of the fair market value of ALO’s assets as compared to the cost basis of its assets. Her analysis revealed a $70.1 million negative net worth.\textsuperscript{155} Paetz’s misgivings about ALO, New Churches Ventures, and BFA prompted her to resign as a BFA accountant in July 1996.

During the seven years Paetz was employed by BFA, she interacted frequently with the Arthur Andersen auditors during each year’s audit. February 1997, during the field work for Arthur Andersen’s 1996 audit of BFA, Paetz decided to contact Arthur Andersen auditor Ann McGrath and set up a lunch meeting with McGrath in order to voice her concerns. At the meeting, Paetz expressed her concern about ALO’s deficit, which was in excess of $100 million and ALO’s monthly losses, which were approximately $2.5 million. In addition, Paetz noted that the money from BFA and New Church Ventures was being used to service ALO’s substantial debt to BFA. Paetz specifically advised McGrath to ask BFA, during the 1996 audit, for detailed financial statements for both ALO and New Church Ventures.

\textbf{Arthur Andersen’s Response to Concerns}

McGrath reported her meeting with Paetz to the engagement partner, Ozer. However, Arthur Andersen’s audit workpapers, and its analysis of fraud risk, did not make reference to the Paetz meeting in February 1997 because McGrath and Ozer considered the meeting to be a “nonevent.”\textsuperscript{156} Arthur Andersen did, however, expand its audit procedures for the 1996 audit and requested from BFA the detailed financial statements of ALO and New Church Ventures. However, BFA refused to make the detailed financial statements of ALO and New Church Ventures available to McGrath and Ozer.

McGrath and Ozer decided not to insist that ALO’s financial statements be provided, although the financial statements were necessary to properly assess ALO’s ability to repay its loans back to BFA and affiliate New Church Ventures. Fortunately, the financial statements of ALO were a matter of public record and part of a four-page annual disclosure statement that ALO had filed with the Arizona Corporation Commission on March 19, 1997, during Arthur Andersen’s field work for the 1996 audit. This four-page annual report showed a $116.5 million negative net

\textsuperscript{155} Ibid., 29–30.

\textsuperscript{156} Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 50–51.
worth as of year-end 1996, and a $22 million net loss for the year.\textsuperscript{157} New Church Ventures’ unaudited detailed financial statements were available for years 1995, 1996, and 1997. These financial statements revealed that substantially all of New Church Ventures’s notes receivable were from ALO.\textsuperscript{158}

**Disclosure of ALO and New Church Ventures in 1996 Financial Statements**

Footnote 3 to BFA’s combined financial statements as of December 31, 1996, included an unaudited condensed balance sheet for New Church Ventures (identified only as “a company associated with Southern Baptist causes”) as of year end 1996, which reported net assets of $2.5 million and total assets of $192.5 million. The footnote did not disclose ALO’s financial position or that approximately 81 percent of New Church Ventures’ assets were notes receivable from ALO. Of course, to the extent New Church Ventures receivables from ALO were uncollectible due to ALO’s negative net worth, New Church Ventures would not be able to meet its liabilities, which included liabilities to IRA holders by year-end 1996 that totaled $74.7 million.\textsuperscript{159}

**Case Questions**

1. Please consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Define what is meant by control environment. Based on the information provided in the case, why does the control environment have a “pervasive” effect on the reliability of financial reporting at an audit client like BFA?

2. Consult Paragraphs #55–59 of PCAOB Auditing Standard No. 2 and Section 301 of SOX. What is the role of the audit committee in the financial reporting process? Can you provide an example of how the Audit Committee may have been helpful in the BFA situation?

3. What is meant by the term “whistleblower” within the context of the financial reporting process? Do you think that all whistleblower complaints should go directly to the Audit Committee? Why? Do you think that a whistleblower program would have been helpful at BFA. Why?

4. Do you believe the Arthur Andersen auditors responded appropriately to the information received from BFA’s former accountant, Karen Paetz? Do you believe any circumstances exist where an auditor should ignore

\textsuperscript{157} Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 30–31.

\textsuperscript{158} Ibid., 30–32.

\textsuperscript{159} Ibid., 31–32.
information from a whistleblower?

5. Please consult Section 401 of SOX. How would Section 401 apply on the BFA audit? Do you believe that Section 401 should apply to an organization like BFA? That is, do you think the section would have improved the presentation of BFA’s financial statements?
Case 3.5

The Fund of Funds: A Focus on Company Level Controls

Synopsis

As total assets reached $617 million in 1967, The Fund of Funds (FOF) was the most successful of the mutual funds offered by the Investor Overseas Services, Limited. In the late 1960s, FOF diversified into natural-resource asset investments. To do so, it formed a relationship with John King, a Denver oil, gas, and mineral investor and developer, whereby FOF would purchase oil and gas properties directly from his company, King Resources. By the 1970s, FOF was forced into bankruptcy.

It was later uncovered that King Resources had dramatically overcharged FOF for the properties that it sold to FOF. FOF’s bankruptcy trustee sued Arthur Andersen for failing to inform FOF that they were being defrauded by King Resources. Arthur Andersen was ultimately found liable and forced to pay around $70 million in civil damages, while John King was charged and convicted for masterminding the fraud against FOF.

Background

FOF incorporated FOF Proprietary Funds, Ltd. (FOF Prop) as an umbrella for specialized investment accounts that were managed by its investment advisors. One of these accounts was the National Resources Fund Account (NRFA), which was dedicated to investments in oil, gas, and mineral assets. Although no formal written agreement established King Resources Corporation (KRC) as the investment advisor for the NRFA, FOF’s clear intent was to use KRC’s expertise to locate and purchase speculative natural resource investments. FOF had no means of independently valuing the assets proposed by KRC for investment.160

Revaluations

FOF was required to value its investment portfolio on a daily basis because the company redeemed shares on the basis of its daily share value. The daily share value was determined by dividing the net asset value of FOF’s entire portfolio by the number of outstanding shares. FOF relied on the advice of KRC for the revaluations of its natural resource assets contained in the NRFA. Because of its speculative nature and the lack of an active trading market, determining the value of its natural resource interests was very difficult.\(^{161}\)

Fox-Raff

In late 1968, KRC’s founder and owner John King arranged a deal with Robert Raff, president of a Seattle brokerage firm, whereby Raff would purchase 10 percent of a specific natural resource interest that was owned by FOF. The sale was designed to provide a basis for the revaluation of FOF’s remaining 90 percent interest in the natural resource interest. The purchase price for Raff’s 10 percent interest totaled $440,000, with an $88,000 down payment required. The transaction provided a basis for FOF to write-up the valuation of its 90 percent interest in the specific natural resource interest by $820,000.

To execute the deal, King actually advanced Raff all of the money that was needed to make the down payment, and assured Raff that no further financial commitment was necessary. Raff intended to sell the investment within six months, so that he would never have to meet the remaining financial obligations to FOF. When FOF pressed for payment, KRC would provide Raff with the means to pay.

Andersen’s auditors questioned whether the 10 percent sale was sufficient enough to establish the value of the whole parcel. They also questioned the basis for the write-up due to the short holding period for the natural resource interest, as well as the lack of any oil strikes or any new geological information that would justify the revaluation of the parcel. Arthur Andersen resolved to express these concerns in a letter to the Board of Directors of FOF, but, ultimately, never sent such a letter. The Arthur Andersen partner working on the year-end 1968 FOF audit, John Robinson, told Edward Cowett, the COO of FOF, that Andersen could accept the Fox-Raff transaction as a basis for

revaluation only because it was immaterial to the financial statements as a whole.

Development of Guidelines for Revaluation\textsuperscript{162}

In the fall of 1969, Andersen sought to establish guidelines for unrealized appreciation or revaluations to allow for “substantive independent evidence for reviewing the reasonableness of the client’s valuations.” A November 7, 1969 memorandum set out Arthur Andersen’s proposal:

Any significant increase in the value of natural resource properties over original cost to FOF must, for audit purposes, be supported by either:

(1) An appraisal report rendered by a competent, independent expert, or

(2) an arms-length [sic] sale of a sufficiently large enough portion of a property to establish a proportionate value for the portion retained …

On the question of what constitutes adequate sales data for valuation purposes (i.e., the 10% question), we have proposed the following to King Resources Company:

(1) No unrealized appreciation would be allowed on sales of relatively small percentages of properties to private investors or others who do not have the necessary expertise to determine a realistic fair market value. By “relatively small,” we envision approximately 50% as being a minimum level in this type of sale to establish proportionate values for the remaining interests. This would preclude any unrealized appreciation on sales such as the December, 1968, sales to Fox-Roff, [sic] Inc. since it could not be reasonably sustained that a brokerage firm has the expertise necessary to evaluate primarily undeveloped resource interests.

(2) Appreciation would be allowed if supported by arms-length [sic] sales to knowledgeable outside parties. For example, if King Resources Company sold a 25% interest in the Arctic permits to Texaco or another major oil company, we believe it would be appropriate to ascribe proportionate value to the 75% retained. Just where to draw the line on the percentage has not been clearly established. We feel 10% would be a bare minimum and would like to see a higher number,…

The senior Andersen partner responsible for audit practices, John March, suggested a sale of a “25–30 percent minimum,” as a more conservative figure, and stated that it “must be a cash deal with no take-out option.” Yet, the guideline finally adopted by FOF for inclusion in the 1969 Annual Report did not specify a fixed percentage that must be sold and also did not refer to the identity or attributes of a buyer. (See Exhibit 3.5.1.)

**Arctic Revaluation**

In late 1969, King arranged for a sale of 9.375 percent of his group’s Arctic interest to John Mecom and Consolidated Oil & Gas (COG) to justify a revaluation for FOF. Essentially, this sale was the basis for a $119 million increase in the valuation of FOF’s interest in the Arctic interest. Details of the transaction were provided in the 1970 FOF Annual Report. (See Exhibit 3.5.2.)

John Mecom, who also owned U.S. Oil of Louisiana, Inc., which had lost $11,458,000 for the year ending September 30, 1969, faced debts of over $132,000,000 at this time. As a result of Mecom’s overall cash problems at that time, King agreed to provide the entire $266,000 down payment for the Arctic transaction, with the subsequent $10 million in payments being provided by KRC’s projected usage of Mecom’s oil and drilling equipment. Exhibit 3.5.3 shows the written side agreement which enabled Mecom to make the Arctic purchase. Interestingly, Arthur Andersen also audited Mecom from its Houston office and, therefore, knew of his financial difficulties.

In addition, COG was a Denver-based oil and gas concern headed by John King’s personal friend. King Resources had joined together with COG in several previous business transactions, a fact that Arthur Andersen was well aware of. To facilitate the Arctic transaction, King arranged for COG to get a $600,000 loan from a Tulsa, Oklahoma bank, without which COG would not have entered into the Arctic transaction.

Andersen obtained representation letters from KRC that the Arctic sale was bona fide. Although Andersen

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164 In February 1968, Leonard Spacek, Andersen’s managing partner, met with King and Mecom to discuss integration of the King and Mecom organizations. Spacek also discussed a role for KRC in refinancing Mecom’s debts in May 1968 and, in December 1968, Spacek discussed the possibility of a King-Mecom joint venture with the Houston office of AA.
obtained representation letters from Mecom and COG confirming the terms of the Arctic purchase agreement, no
inquiry was made of Mecom or COG as to the existence of possible side agreements. Andersen also obtained a Dun
& Bradstreet report on Mecom, which likely would have showed his cash flow problems. In May 1970, prior to
issuing FOF’s report, Andersen learned of a Wall Street Journal article that cast doubt on COG’s obligation related
to the sale. Andersen obtained a reconfirmation from KRC, discussed the matter with COG’s principal, and obtained
a reconfirmation specifically excluding side deals, but no further inquiry about side deals was made to Mecom. In
late May 1970, Andersen decided that a “subject to” qualification was necessary in issuing its report concerning FOF
as of year-end 1969. (See Exhibit 3.5.4.)

Exhibit 3.5.1

Revaluation Guideline Adopted by FOF for Inclusion in the 1969 Annual Report

Natural resources

The following sets forth the present guidelines established by the Boards of Directors of the fund and Proprietary
with respect to the valuation of natural resource properties. Such guidelines have been consistently followed.

a. Such properties are carried at cost, until an event of such obvious and compelling significance occurs as to
require a change in that value. Discovery of a mineral interest, determination of the property being unproductive
through testing or other geological evaluation, or a sale of all or a portion of the property held would be among
the factors which would constitute such an event.

b. A partial sale may be used as a basis for evaluation of unrealized appreciation on the remaining holdings when
such sale is at arm’s length, and when a sufficient percentage of Proprietary’s holding is sold.

c. Outside appraisals are used only in those cases where the Boards of Directors are satisfied that there is
appropriate substance to recognition of unrealized appreciation on the basis of appraisal. However, where
significant unrealized appreciation is involved, independent appraisals may not be considered sufficient and
demonstration of the current realizability of such appreciation through a consummated sale may be required.

Source: The Fund Of Funds, Limited, F.O.F. Proprietary Funds, Ltd., And IOS Growth Fund, Limited, A/K/A
Transglobal Growth Fund, Limited, Plaintiffs, v. Arthur Andersen & Co., Arthur Andersen & Co. (Switzerland), And
Exhibit 3.5.2

Arctic Revaluation Transaction Description in 1970 FOF Annual Report

In January 1970, Proprietary concluded a sale for its subsidiaries of 10 percent of their interests in the Arctic permits. This sale was made to the operator of the permit interests on the same bases and terms as a December, 1969, sale by such operator of a 9.375% interest to outside third parties. Sales proceeds consisted of $779,300 cash down payment and $7,570,000 payable in six semi-annual installments beginning in 1973 and bearing interest at 6% per annum. The sales agreement also relieves the sellers of 80% of the first $10,436,500 of their commitment for exploration costs. The purchasers have thereby assumed an obligation for exploration costs which is $7,305,500 in excess of such costs applicable to their interests in the permits.

Based on the terms of the sale outlined above, and as approved by the Boards of Directors of the Fund and Proprietary, Proprietary has valued its subsidiary’s interest in the Arctic permits at $119,000,000. Such value represents a gross valuation of $156,000,000 less, (a) discounting to provide an effective 8-1/2% interest rate on permit payments and an effective 10% interest rate on excess work obligation payments ($20,000,000) and, (b) the 12-1/2% net operating profits interest ($17,000,000). The portion of that valuation applicable to Proprietary is $114,240,000, equal to $10.60 per net acre. After deduction of management fees and income taxes, the Fund’s value per net acre is $8.01.


Exhibit 3.5.3

Side Agreement with Mecom to Make the Arctic Purchase
Dear Mr. Mecom:

This is to confirm my agreement with you in connection with your purchase from King Resources Company of approximately 347,883 net acres of oil and gas exploration permits in the Canadian Arctic Islands for $7.50 per acre plus $7.50 per acre in work obligations under the terms of an agreement with King Resources Company dated December 24, 1969.

I have agreed to provide sufficient net cash receipts to be paid to you to enable you to make all payments on your said contract with King Resources Company through payments due in October, 1971.

At any time after October 1971 up to December 31, 1971, I have also agreed that if you so request and assign to me your interest to said permits, I will assume and pay and hold you harmless from all obligation to pay all amounts due King Resources under said contract subsequent to October, 1971. Provided that if, prior to October 1971, you are afforded an opportunity to sell your interests at a price in excess of your costs, my further obligations hereunder shall cease.

This letter will be held for our mutual account by Timothy G. Lowery [sic] of Peterson, Lowry, Rall Barger & Ross of Chicago, Illinois.


Exhibit 3.5.4

1969 Auditor Opinion

To the Shareholders and Board of Directors,

The Fund of Funds, Limited:

We have examined the consolidated statements of net assets and investments of The Fund of Funds, Limited (an Ontario, Canada, corporation) and subsidiary as of December 31, 1969, and the related consolidated statements of fund operations and changes in net assets for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other
auditing procedures as we considered necessary in the circumstances. Investments owned by the Fund at December 31, 1969, were confirmed directly to us by the custodian or brokers. The position of investments sold short was confirmed directly to us by the custodian or brokers. Consistent with past practice, certain investments, in the absence of quoted market prices, have been valued by the Board of Directors as indicated in Note 9. These valuations have been reviewed by us to ascertain that they have been determined on the bases described, but since we are not competent to appraise these investments we do not express an opinion as to such valuations.

In our opinion, subject to the effect of certain investment valuations referred to in the preceding paragraph, the above-mentioned financial statements present fairly the financial position of The Fund of Funds, Limited and subsidiary as of December 31, 1969, and the results of their operations and the changes in their net assets for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.


Case Questions

1. Consult Paragraph #7 of PCAOB Auditing Standard No. 2. Do you believe that FOF has established an effective system of internal control over financial reporting related to the valuation of its natural resource assets? Why or why not?

2. Please consider the valuation assertion related to the natural resources assets. Do you think it is reasonable for an auditor to rely on a recent sale of a 10 percent interest as evidence to justify a revaluation of FOF’s remaining 90 percent interest in the natural resource assets? Why or why not?

3. What other evidence could an auditor seek to justify the valuation of an asset where there is no active trading market? Please comment on whether Arthur Andersen’s guidelines for the appreciation of national resource properties were appropriate under the circumstances. Why or why not?

4. Based on your understanding of fraud risk assessment, what three conditions are likely to be present when a
fraud occurs? Based on your understanding of the FOF audit, which of these three conditions appears to be most prevalent, and why?
Case 3.6

WorldCom: A Focus on Internal Controls

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.

“Hit” the Numbers

Even as conditions in the telecommunications industry deteriorated in 2000 and 2001, WorldCom continued to post impressive revenue numbers. In April 2000, CEO Ebbers told analysts that he “remain[ed] comfortable with … 13.5 to 15.5 percent revenue growth in 2000.” In February 2001, Ebbers again expressed confidence that WorldCom Group could repeat that performance: “On the WorldCom side of the business, we are sticking with our 12 percent to 15 percent revenue growth guidance for 2001. Let me restate that. On the WorldCom side of the business, we are sticking with our 12 percent to 15 percent revenue growth guidance for 2001.”

Monitoring of Revenue at WorldCom

According to several accounts, revenue growth was emphasized within WorldCom; in fact, no single measure of performance received greater scrutiny. On a regular basis, the sales groups’ performances were measured against the revenue plan. At meetings held every two to three months, each sales channel manager was required to present and defend his or her sales channel’s performance against the budgeted performance.

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165 Board of Directors’ Special Investigative Committee Report, June 9, 2003, 133.
Compensation and bonus packages for several members of senior management were also tied to double-digit revenue growth. In 2000 and 2001, for instance, three executives were eligible to receive an executive bonus only if the company achieved double-digit revenue growth over the first six months of each year.\footnote{Ibid., 133–134.}

**Monthly Revenue Report and the Corporate Unallocated Schedule**

The principal tool by which revenue performance was measured and monitored at WorldCom was the monthly revenue report ("MonRev") prepared and distributed by the revenue reporting and accounting group (hereafter referred to the revenue accounting group). The MonRev included dozens of spreadsheets detailing revenue data from all of the company's channels and segments. The full MonRev contained the Corporate Unallocated schedule, an attachment detailing adjustments made at the corporate level and generally not derived from the operating activities of WorldCom’s sales channels. WorldCom’s Chief Financial Officer and Treasurer Scott Sullivan had ultimate responsibility for the items booked on the Corporate Unallocated schedule.\footnote{Ibid., 135–139.}

In addition to CEO Ebbers and CFO Sullivan, only a handful of employees outside the revenue accounting group regularly received the full MonRev. Most managers at WorldCom received only those portions of the MonRev that were deemed relevant to their position. Sullivan routinely reviewed the distribution list for the full MonRev to make sure he approved of everyone on the list.\footnote{Ibid., 135–139.}

The total amounts reported in the Corporate Unallocated schedule usually spiked during quarter-ending months, with the largest spikes occurring in those quarters when operational revenue lagged furthest behind quarterly revenue targets—the second and third quarters of 2000 and the second, third, and fourth quarters of 2001. Without the revenue that was recorded in the Corporate Unallocated account, WorldCom would have failed to achieve the double-digit growth it reported in 6 out of 12 quarters between 1999 and 2001.\footnote{Ibid., 140–141.}

**Process of Closing and Consolidating Revenues**
WorldCom maintained a fairly automated process for closing and consolidating operational revenue numbers. By the tenth day after the end of the month, the revenue accounting group prepared a draft “Preliminary” MonRev that was followed by a Final MonRev, which took into account any adjustments that needed to be made. In nonquarter-ending months, the Final MonRev was usually similar, if not identical, to the Preliminary MonRev.\textsuperscript{170}

In quarter-ending months, however, top-side adjusting journal entries, often very large, were allegedly made during the quarterly closing process, in order to hit revenue growth targets. Investigators later found notes made by senior executives in 1999 and 2000 that calculated the difference between “act[ual]” or “MonRev” results and “target” or “need[ed]” numbers, and identified the entries that were necessary to make up that difference. CFO Scott Sullivan directed this process, which was allegedly implemented by Ron Lomenzo, the Senior Vice President of Financial Operations, and Lisa Taranto, an employee who reported to Lomenzo.\textsuperscript{171}

Throughout much of 2001, WorldCom’s revenue accounting group tracked the gap between projected and targeted revenue—an exercise labeled “Close the Gap”—and kept a running tally of accounting “opportunities” that could be exploited to help make up that difference.\textsuperscript{172}

Many questionable revenue entries were later found within the Corporate Unallocated revenue account. On June 19, 2001, as the quarter of 2001 was coming to a close, CFO Sullivan left a voicemail for CEO Ebbers that indicated his concern over the company’s growing use of nonrecurring items to increase revenues reported:

> Hey Bernie, it’s Scott. This MonRev just keeps getting worse and worse. The copy, um the latest copy that you and I have already has accounting fluff in it…all one time stuff or junk that’s already in the numbers. With the numbers being, you know, off as far as they are, I didn’t think that this stuff was already in there…We are going to dig ourselves into a huge hole because year to date it’s disguising what is going on the recurring, uh, service side of the business…\textsuperscript{173}

\textsuperscript{170} Ibid., 140–141.

\textsuperscript{171} Ibid., 14.

\textsuperscript{172} Ibid., 141.

\textsuperscript{173} Ibid., 15.
A few weeks later, Ebbers sent a memorandum to WorldCom’s COO Ron Beaumont that directed him to “see where we stand on those one time events that had to happen in order for us to have a chance to make our numbers…” Yet, Ebbers did not give any indication of the impact of nonrecurring items on revenues in his public comments to the market in that quarter or in other quarters. For that matter, the company did not address the impact of nonrecurring items on revenues in its earnings release or public filing for that quarter or prior quarters as well.174

Case Questions

1. Consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Please define what is meant by control environment. Why does the control environment have a “pervasive” effect on the reliability of financial reporting at an audit client like WorldCom?

2. Consider Paragraph #63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Please identify one relevant financial statement assertion related to the revenue account that is impacted by corporate unallocated revenue activity. Why is it relevant?

3. Please explain what is meant by a “top-side” adjusting journal entry. If you were auditing WorldCom, what type of documentary evidence would you require to evaluate the propriety of a “top-side” journal entry made to the revenue account?

4. Please consult Q38 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of WorldCom’s control environment and other company level controls would help you implement a “top-down” approach to an internal control audit at WorldCom.

5. Consider Paragraph #25 of PCAOB Auditing Standard No. 2. For WorldCom’s corporate unallocated revenue activity, discuss an internal control procedure that would help to prevent, detect, or deter fraud related to the corporate unallocated revenue activity.

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174 Ibid., 15.
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.”

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.

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

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176 Ibid., 174–176.
savings or result in additional revenues.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{181}

\textsuperscript{177} Ibid., 186–187.
\textsuperscript{178} Ibid., 194–195.
\textsuperscript{179} Ibid., 194–195.
\textsuperscript{180} Ibid., 190–191.
\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

\textsuperscript{182} Ibid., 190–191.

\textsuperscript{183} Ibid., 192–193.

\textsuperscript{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

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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?).
Case 3.8

Qwest: A Focus on Company Level Controls

Synopsis

When Joseph Nacchio became Qwest’s CEO in January 1997, its existing strategy to construct a fiber-optic network across major cities in the United States began to shift toward communications services as well. By the time it released earnings in 1998, Nacchio proclaimed Qwest’s successful transition from a network construction company to a communications services provider. “We successfully transitioned Qwest … into a leading Internet protocol-based multimedia company focused on the convergence of data, video, and voice services.”188

During 1999 and 2000, Qwest consistently met its aggressive revenue targets and became a darling to its investors. Yet, it was later uncovered that Qwest had fraudulently recognized $3.8 billion in revenues and fraudulently excluded $231 million in expenses. When the company announced its intention to restate revenues, its stock price plunged to a low of $1.11 per share in August 2002, from a high of $55 per share in July 2000. During this period, its market capitalization declined by 98 percent, from a high of $91 billion to a low of $1.9 billion.189

Background

To facilitate its growth in communications services revenue, Qwest unveiled an aggressive acquisition strategy in the late 1990s. Indeed, after a slew of other acquisitions, Qwest entered into a merger agreement with telecommunications company US West on July 18, 1999. The merger agreement gave US West the option to terminate the agreement if the average price of Qwest stock was below $22 per share or the closing price was below $22 per share for 20 consecutive trading days. Less than a month after the merger announcement, Qwest’s stock price had dropped from $34 to $26 per share. So, to prevent any further drops in its stock price, executives and managers were pressured by CEO Nacchio to meet earnings targets to ensure that the price per share did not fall


189 SEC v. Qwest, 1–2.
below the level specified in the agreement. Although Qwest’s stock price had dropped from $34 to $26 per share less than a month after the merger announcement, Qwest stock was trading above $50 per share by June 2000; Qwest was, therefore, able to acquire US West by using Qwest’s common stock.

Following the merger, Qwest’s senior management set ambitious targets for revenue and earnings of the merged company. These targets were especially ambitious in the face of difficult industry conditions. For example, in Qwest’s earnings release for the second quarter 2000, on July 19, 2000, Nacchio said that Qwest would “generate compound annual growth rates of 15–17 percent revenue … through 2005.” At a January 2001 all-employee meeting, Nacchio stated his philosophy on the importance of meeting targeted revenues:

[T]he most important thing we do is meet our numbers. It’s more important than any individual product, it’s more important than any individual philosophy, it’s more important than any individual cultural change we’re making. We stop everything else when we don’t make the numbers.

Challenges

By 1999, Qwest encountered several obstacles that challenged its ability to meet its aggressive revenue and earnings targets. It faced increased competition from long distance providers, steep declines in the demand for Internet services, an overcapacity in the market resulting from the formation of other major fiber-optic networks, and a decline in the price at which Qwest could sell its excess fiber-optic capacity due to the increase in capacity.

Despite these significant industry challenges, Qwest’s senior management publicly claimed that the company would continue its pattern of dramatic revenue increases because of a “flight to quality” that customers would enjoy when they left competitors to use Qwest’s services. Within the company, Qwest senior management exerted extraordinary pressure on their subordinate managers and employees to meet or exceed the publicly announced revenue targets. In addition, they only paid bonuses to management and employees for periods when they achieved targeted revenue.

Sale of Network Assets Initially Held for Use and Capital Equipment

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190 SEC v. Qwest, 6–7.

191 SEC v. Qwest, 7–8.

192 SEC v. Qwest, 8.
To help meet revenue targets, senior management also began to sell portions of its own domestic fiber-optic network. Originally, this network was to be held for Qwest’s own use and had previously been identified as the “principal asset” of Qwest. Specifically, Qwest sold indefeasible rights of use (IRUs), for specific fiber capacity that it had constructed and used in its own communications services business. In addition, Qwest sold pieces of the network it had acquired from other third parties. Finally, Qwest sold used capital equipment to generate additional revenue.

Unlike recurring service revenue from its communication services business that produced a predictable amount of revenue in future quarters, revenue from IRUs and other equipment sales had no guarantee of recurrence in future quarters. In fact, both IRUs and equipment sales were referred to internally as “one hit wonders.”

In its earnings releases during 1999 through 2001, Qwest executives would often fail to disclose the impact of nonrecurring revenues. (See Table 3.8.1.) In its earnings releases and the Management’s Discussion and Analysis portion of its SEC filings, Qwest improperly characterized nonrecurring revenue as service revenue, often within the “data and Internet service revenues” line item on the financial statements. Qwest’s nonrecurring revenue was included primarily in the wholesale services segment, and to a lesser extent, the retail services segment.

### TABLE 3.8.1 Management’s Failure to Disclose Impact of Nonrecurring Revenue

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2Q 1999</td>
<td>Failed to disclose that nonrecurring revenue made up 96 percent of data and Internet services revenue, 192 percent of the growth in data and Internet services, and 19 percent of total revenue. Excluding nonrecurring revenue, data and Internet services revenue actually declined 92 percent from the same quarter of the previous year.</td>
</tr>
<tr>
<td>3Q 1999</td>
<td>Failed to disclose that nonrecurring revenue made up 140 percent of Qwest’s reported data and Internet services revenue, and 32 percent of total revenue. Excluding nonrecurring revenue, total revenue actually declined 13 percent from the same quarter of the previous year.</td>
</tr>
<tr>
<td>4Q 1999</td>
<td>By the end of 1999, nonrecurring revenue comprised 33 percent of total revenue for the fourth quarter, and 26 percent of Qwest’s total revenue for the year. Without inclusion of the non-recurring revenue, revenue for the fourth quarter and for the year would have actually declined from the previous year.</td>
</tr>
</tbody>
</table>

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revenue, Qwest’s fourth quarter total revenue declined nine percent from the same quarter of the previous year. Qwest’s corporate accounting department drafted proposed disclosure language for the company’s 1999 Form 10-K detailing the amount of IRU revenue, but Qwest’s CFO and CEO, rejected the language and refused to disclose any material information about nonrecurring revenue in the 1999 Form 10-K filed on March 7, 2000.

1Q 2000
By the end of the quarter, nonrecurring revenue comprised 97 percent of data and Internet services revenue, and 29 percent of total revenue. Without nonrecurring revenue, data and Internet services declined 92 percent from the same quarter of the prior year, and total revenue grew only 17 percent over the same quarter of the previous year. (This information was not disclosed.)

2Q 2000
Did not disclose that nonrecurring revenue made up 86 percent of data and Internet services revenue, and 29 percent of total revenue. Excluding nonrecurring revenue, total revenue grew only 23 percent.

3Q 2000
Even after acquiring US West, which resulted in a fivefold increase in revenue, nonrecurring revenue made up 35 percent of data and Internet service revenue, and eight percent of total revenue. The company continued not to disclose this information to the public.

1Q 2001
Contrary to Qwest’s statements, during the first quarter 2001, nonrecurring revenue was 36 percent of data and Internet services revenue, 11 percent of total revenue, and 35 percent of Qwest’s total revenue growth. Excluding nonrecurring revenue, Qwest’s total revenue grew only eight percent over the same period of the previous year.

2Q 2001
Did not disclose that nonrecurring revenue had grown to 13 percent of total revenue, and 39 percent of data and Internet services revenue. Without including the nonrecurring revenue, Qwest’s total revenue grew only six percent over the same period of the previous year.

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**Case Questions**

1. Please consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Define what is meant by control environment. Why does the “tone at the top” have a “pervasive” effect on the reliability of financial reporting at an audit client like Qwest? Based on the case information, do you believe that the proper “tone at the top” was established at Qwest? Why or why not?
2. Please consult Q38 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of Qwest’s control environment and other company level controls would help you implement a “top-down” approach to an internal control audit at Qwest.

3. Consider Paragraph #63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Please identify the most relevant financial statement assertion related to the nonrecurring revenue (i.e., “one-hit wonders”). Why is it the most relevant?

4. Please consider Paragraph #72 of PCAOB Auditing Standard No. 2. How would you classify the nonrecurring revenue (i.e., “one-hit wonders”)? Why?

5. Consult Q5 of the PCAOB Staff Questions & Answers (June 23, 2004) and your primary audit text. What is the auditor’s responsibility related to information disclosed by management at the time of an earnings release, if any? What is the auditor’s responsibility related to the information disclosed by management in the Management’s Discussion & Analysis section, if any? Do you agree with these responsibilities? Why or why not?
Case 3.9

Waste Management: A Focus on Top-Side Adjusting Entries

Synopsis

In February 1998, Waste Management announced that it was restating the financial statements it had issued for the years 1993 through 1996. In its restatement, Waste Management said that it had materially overstated its reported pretax earnings by $1.43 billion. After the announcement, the company's stock dropped by more than 33 percent and shareholders lost over $6 billion.

The SEC brought charges against the company’s founder Dean Buntrock and five other former top officers. The charges alleged that management had made repeated changes to depreciation-related estimates to reduce expenses and had employed several improper accounting practices related to capitalization policies, also designed to reduce expenses.¹⁹⁶

Top-Side Adjusting Journal Entries

Top-side adjusting journal entries are typically made by upper managers at the very end of the reporting process, usually at corporate headquarters. Because these journal entries are typically not generated at the level of the business process (e.g., Internet sales) or at the business unit level (e.g., the North American Division), they can be used as a way for upper managers to circumvent the internal control system and perpetrate a fraud.

To help perpetrate its accounting fraud, management at Waste Management allegedly made use of top-side adjusting journal entries in the process of consolidating the results reported by their operating groups. Upper management allegedly employed a number of improper accounting practices (to reduce expenses, thereby inflating earnings) and used top-side adjusting journal entries to intentionally hide the fraud from both their operating groups and the investing public.

¹⁹⁶ SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).
It was not uncommon for Waste Management to make use of top-side adjusting entries when consolidating the results of several of its business units to prepare its annual and quarterly financial statements. Indeed, Waste Management’s use of several unbudgeted and unsupported top-side adjustments in the early 1990s caused observers (including Arthur Andersen) to question whether management had employed these adjustments as tools to help “manage” their reported earnings.

Waste Management set its earnings’ targets during an annual budget process. The company followed a “top down budgeting process” whereby the CEO (Buntrock until 1996 and Rooney after Buntrock’s retirement until early 1997) set goals for earnings growth, and the operating units would, in turn, determine their budgets based on the goals set at the top. The budgets were then consolidated to arrive at the budgeted consolidated earnings. At this time, the upper managers also set budgets for the anticipated top-side adjustments, which were based on the existing accounting assumptions used.

**Closing the Gap**

As operating results were recorded by Waste Management’s operating units at the end of each quarter, upper management monitored the gap between the results and the goals. Management then made a number of different types of unbudgeted top-side adjusting entries in the financial statements in an effort to “close the gap.” For example, a top-side adjustment might have been used to: (1) reduce the allowance for doubtful accounts (or another reserve account); (2) extend the useful lives of trucks by two years; or (3) double the salvage values of trucks, depending on the nature and size of the budget gap.

Management did not disclose to investors the impact of the top-side adjustments on the company’s earnings. In fact, management did not inform its own internal operating units about the top-side adjusting entries that were made and their resulting impact on reported net income.

As early as 1992, the company’s auditor Arthur Andersen advised management against its use of top-side adjusting entries in a postaudit letter recommending accounting changes. Andersen auditors wrote that “individual decisions are not being evaluated on the true results of their operations” as a result of the extensive use of top-side adjustments. Andersen recommended that “all such corporate adjustments should be passed back to the respective” divisions. Instead of following this recommendation, top management seemed to increase the budget for the top-side adjustments from 1992 to 1997 and, each year, the actual adjustments made exceeded the budgeted adjustments. From the first quarter of 1992 through the first quarter of 1997, top management allegedly used unsupported top-
side adjustments in 14 of the 21 quarters to achieve reported results within the range of the company’s public earnings projections.

**Case Questions**

1. In your own words, please explain what is meant by a “top-side” adjusting journal entry. If you were auditing Waste Management, what type of documentary evidence would you require to evaluate the propriety of a “top-side” journal entry?

2. Please consult Paragraph #16 PCAOB Auditing Standard No. 2. Based on the case information, do you think this paragraph relates to the use of “top-side” adjusting journal entries at Waste Management? Why or why not?

3. Consult Paragraphs #76–78 of PCAOB Auditing Standard No. 2. Do you believe that the period-end financial reporting process should always be a significant process in an audit of internal control? Why or why not?

4. Please refer to Paragraphs #84–85 of PCAOB Auditing Standard No. 2. Identify one specific control procedure that could be designed to prevent the occurrence of or detect a misstatement related to a top-side adjusting entry.
Section 4

Audit of Accounts, Processes, and Assertions

In formulating the post-Sarbanes technical audit guidance, the PCAOB has made it clear that detecting fraud must be the focus of the audit process. Consider that “fraud” was mentioned on 76 different occasions in PCAOB Auditing Standard No. 2.

Of course, if designed and operating effectively, a company’s internal control system should prevent or detect fraud related to management’s assertions about the financial statements. As a result, it is absolutely essential for auditors to understand the relationship between a company’s internal control system and the financial statement assertions. In this spirit, the cases in this section are designed to provide a mechanism to illustrate the explicit linkage between an internal control activity and the financial statement assertion being supported using different examples of economic transaction activity.

The case readings have been developed solely as a basis for class discussion. The case readings are not intended to serve as a source of primary data or as an illustration of effective or ineffective auditing.

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Case 4.1

Enron: A Focus on Evidence—The Chewco Special Purpose Entity

Synopsis

In its 2000 Annual Report, Enron prided itself on having “metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business
approach and its innovative people.”\textsuperscript{197} Enron’s strategy seemed to pay off; in 2000, it was the seventh largest company on the Fortune 500, with assets of $65 billion and sales revenues of $100 billion.\textsuperscript{198} From 1996 to 2000, its revenues had increased by more than 750 percent and 65 percent per year, which was unprecedented in any industry.\textsuperscript{199} Yet, just a year later, Enron filed for bankruptcy, and billions of shareholder dollars and retirement savings were lost.

In 2002, Enron’s auditor Arthur Andersen LLP, one of the five largest international public accounting firms, was convicted of obstruction of justice in connection with shredding documents related to the Enron audit. And although this conviction was overturned in 2005 by the United States Supreme Court, Andersen’s decision to destroy evidence cast suspicion on whether Andersen was trying to cover up any guilt related to a failure to perform its professional responsibilities.

\textbf{Background}

Enron was created in 1985 by the merger of two gas pipeline companies: Houston Natural Gas and InterNorth. Enron’s mission was to become the leading natural-gas pipeline company in North America. As it adapted to changes in the natural gas industry, Enron changed its mission, expanding into natural gas trading and financing, and into other markets, such as electricity and other commodity markets.

In the process, Enron also made significant changes to several of its accounting procedures. For example, Enron began establishing several “special purpose entities” in many aspects of its business. A special purpose entity (SPE) is an entity—partnership, corporation, trust, or joint venture—created for a limited purpose, with limited activities and a limited life. A company forms an SPE so outside investors are assured they will only be exposed to the risk of the SPE and its particular purpose, such as building a gas pipeline, and not to the risks associated with the entire company. In addition, the SPE also protects the investment of outside investors by giving them control over its

\textsuperscript{197} Enron 2000 Annual Report, p. 7.

\textsuperscript{198} Joseph F. Berardino, Remarks to U.S. House of Representatives Committee on Financial Services, December 12, 2001.

activities.

**Conditions for Nonconsolidation of SPEs**

A company is *not* required to consolidate the assets and liabilities of an SPE into those contained on its own balance sheet, and it may record gains and losses on transactions with an SPE, if two conditions are met:

1. An owner independent of the company must own a “substantive” equity interest (of at least 3 percent of the SPE’s assets, and that 3 percent must remain at risk throughout the transaction), and

2. The independent owner must exercise control of the SPE.

The 3 percent minimum equity owned by outside investors was created in 1990 by EITF 90–15 and formalized by FASB Statements No. 125 and No. 140. This standard represented a major departure from typical consolidation rules, which generally required an entity to be consolidated if a company owned (directly or indirectly) 50 percent or more of the entity.\(^\text{200}\) Consolidation rules for SPEs were also controversial because a company could potentially use an SPE for fraudulent purposes, such as keeping debt or nonperforming assets off its own consolidated balance sheet.

**JEDI and Chewco**

In 1993 Enron and the California Public Employees Retirement System (CalPERS) formed an SPE, a $500 million 50–50 partnership they called Joint Energy Development Investments Limited (JEDI).\(^\text{201}\) Enron was not required to consolidate the partnership within Enron’s financial statements because it did not own more than 50 percent of the venture.

In 1997, Enron offered to buy out CalPERS’s interest in JEDI. To maintain JEDI as an unconsolidated entity, Enron needed to identify a new limited partner. Enron’s CFO Andrew Fastow proposed that Enron form another SPE, named Chewco Investments (after *Star Wars* character Chewbacca), the bulk of whose equity investment would...

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\(^{201}\) JEDI was also a sly nod to the *Star Wars* films; CFO Andy Fastow, who devised the partnership, was a *Star Wars* fan.
come from third-party investors, to buy out CalPERS’s JEDI interest.\textsuperscript{202}

**Chewco’s Capital Structure**

Unsuccessful in obtaining outside equity, Enron created a capital structure for Chewco that had three elements:

1. $240 million unsecured subordinated loan to Chewco from Barclays Bank (Enron would guarantee the loan);
2. $132 million advance from JEDI to Chewco under a revolving credit agreement; and
3. $11.5 million in equity (representing approximately 3 percent of total capital) from Chewco’s general and limited partners.\textsuperscript{203}

**Chewco’s Partners**

Michael Kopper, an Enron employee who reported to CFO Fastow, was the general partner of Chewco. The limited partner of Chewco was an entity called Big River Funding LLC, whose sole member was an entity named Little River Funding LLC. Kopper had invested $115,000 in Big River and $10,000 in Little River but transferred these investments to William Dodson (who allegedly may have been Kopper’s domestic partner). As such, Kopper technically had no ownership interest in Chewco’s limited partner. The remaining $11.4 million was provided by Barclays Bank in the form of “equity loans” to Big River and Little River.

Barclays required Big River and Little River to establish cash reserve accounts of $6.6 million and that the reserve accounts be fully pledged to secure repayment of the $11.4 million. JEDI, of which Enron still owned 50 percent, made a special $16.6 million distribution to Chewco, out of which $6.6 million could be used to fund the cash reserve accounts.\textsuperscript{204} (See Figure 4.1.1 for a visual depiction of the Chewco transaction.)

**Andersen’s Audit of the Chewco Transaction**

Enron’s auditor Arthur Andersen requested that Enron provide all of the documentation in its possession relating to


the Chewco transaction. In its audit of the transaction, Andersen allegedly reviewed the following:205

- The minutes of Enron’s Executive Committee of the Board of Directors approving the transaction
- The $132 million loan agreement between JEDI and Chewco
- Enron’s guarantee agreement of a $240 million from Barclays to Chewco
- An amended JEDI partnership agreement
- A representation letter from Enron and a representation letter from JEDI, each of which stated that the related party transactions had been disclosed, and all financial records and related data had been made available to Andersen.

Andersen received confirmation regarding the loan agreement from a Chewco representative. Andersen also requested that Enron provide documents relating to Chewco’s formation and structure. However, Enron allegedly told Andersen that it did not have these documents and could not obtain them because Chewco was a third party with its own legal counsel and ownership independent of Enron.206 Andersen allegedly accepted this explanation and only relied on the evidence it had been given.

When the Chewco transaction was reviewed closely in late October and early November 2001, Enron and Andersen concluded that Chewco was an SPE without sufficient outside equity and that it should have been consolidated into Enron’s financial statements. The retroactive consolidation of Chewco and the investment partnership in which Chewco was a limited partner decreased Enron’s reported net income by $28 million (out of $105 million total) in 1997, by $133 million (out of $703 million total) in 1998, by $153 million (out of $893 million total) in 1999, and by $91 million (out of $979 million total) in 2000. It also increased Enron’s reported debt by $711 million in 1997, by $561 million in 1998, by $685 million in 1999, and by $628 million in 2000.207

**Case Questions**


1. Please consult the key provisions of Emerging Issues Task Force (EITF) 90-15. How did Enron’s Chewco SPE fail to meet the outside equity requirement for nonconsolidation? Did Enron meet the “control” requirement for nonconsolidation?

2. Based on your understanding of the audit evidence, did Arthur Andersen rely on sufficient and competent audit evidence in its audit of the Chewco transaction? Why or why not?

3. Please consult Section 401 of SOX. How would Section 401 apply on the Enron audit? Do you think that Section 401 would have improved the presentation of Enron’s financial statements?

4. Consult Paragraph #60 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. What is the relevant financial statement assertion(s) about which of the financial statement account(s) related to the Chewco transaction? Please provide adequate support for your answer.

FIGURE 4.1.1 Chewco Transaction
Case 4.2

Qwest: A Focus on Evidence—IRU Swap Transactions

Synopsis

When Joseph Nacchio became Qwest’s CEO in January 1997, its existing strategy to construct a fiber-optic network across major cities in the United States began to shift toward communications services as well. By the time it released earnings in 1998, Nacchio proclaimed Qwest’s successful transition from a network construction company to a communications services provider. “We successfully transitioned Qwest … into a leading Internet protocol-based multimedia company focused on the convergence of data, video, and voice services.”\(^{208}\)

During 1999 and 2000, Qwest consistently met its aggressive revenue targets and became a darling to its investors. Yet, it was later uncovered that Qwest had fraudulently recognized $3.8 billion in revenues and fraudulently excluded $231 million in expenses. When the company announced its intention to restate revenues, its stock price plunged to a low of $1.11 per share in August 2002, from a high of $55 per share in July 2000. During this period, its market capitalization declined by 98 percent, from a high of $91 billion to a low of $1.9 billion.\(^{209}\)

Background

Included within the $3.8 billion of revenues that were fraudulently recognized by Qwest were IRU swap transactions. In such transactions, Qwest would sell IRUs to customers in exchange for purchasing fiber or capacity in similar dollar amounts from those same customers. Under GAAP, no revenue should be recognized in this type of swap transaction unless Qwest had a legitimate business need to purchase the IRU capacity simultaneously from the other telecommunications company. Unfortunately, based on the available evidence, it appears that many of Qwest’s IRU swap transactions failed to meet the requirement to recognize revenue. In addition, in some cases, Qwest’s executives backdated documents for IRU swap transactions to enable earlier revenue recognition.


\(^{209}\) SEC v. Qwest, 1–2.
**Business Need for Assets Purchased in IRU Swap Transactions**

Beginning in 1999, Qwest found it increasingly difficult to sell IRUs to customers unless it purchased fiber or capacity in similar dollar amounts from those same customers in transactions referred to as “swaps.” For example, in the third quarter 2001, Qwest agreed to purchase $67.2 million of capacity in Pan America from Global Crossing in a swap transaction because Global Crossing could deliver the capacity by the close of the third quarter, a necessary element for booking revenue on Qwest’s simultaneous sale to Global Crossing. Yet, many of the assets Qwest purchased in swap transactions seemingly did not have a legitimate business purpose, besides their role in the completion of a swap transaction.

**Qwest’s Failure to Use Assets Purchased in Swap Transactions**

In most cases, Qwest did not use the assets that it purchased. For example, on September 29, 2000, Qwest purchased from Global Crossing $20.8 million in capacity across the Pacific Ocean as part of a swap transaction. Qwest never activated the capacity and, six months later, returned the $20.8 million in capacity as a credit toward the purchase of different capacity from Global Crossing. In fact, members of Qwest’s senior management directed and established quotas for the IRU sales teams to resell capacity that Qwest “[took] on as a result of trades with other carriers that we do not intend to use.”

**Qwest’s Purchase of Assets That Duplicated Other Assets It Owned**

Many of the routes Qwest purchased in IRU swaps duplicated network assets that Qwest already possessed. For example, Qwest purchased similar East Asia capacity during 2001 in four swap transactions with Cable & Wireless, Global Crossing, Flag Telecom, and TyCom Networks. Because the routes were redundant, Qwest did not have a business use for at least three of the four routes. In another example, Qwest engaged in a swap with Enron on December 21, 1999, whereby it bought fiber between Denver and Dallas for $39.2 million. However, Qwest had already built and completed a route between those cities that had excess capacity and the ability to be expanded.

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211 SEC v. Qwest, 32.
212 SEC v. Qwest, 30.
213 SEC v. Qwest, 32–33.
Interaction of IRU Sales Staff with Network Planning Department

Although Qwest’s network planning department was responsible for determining what capacity was needed to expand or develop Qwest’s fiber-optic network, Qwest’s IRU salespeople did not generally consult with the network planning department before purchasing assets in a swap. In those few instances when Qwest’s network planning department was consulted, it recommended against the purchase of capacity because Qwest had little or no need for the IRU. For example, prior to the purchase of a large amount of fiber from Enron in a third quarter 2001 swap, in which Qwest recognized $85.5 million in revenue on the sale, Qwest’s network planning group made it clear that the Qwest network had no need for the majority of Enron’s fiber route and other assets.

Study on Use of International Capacity Purchased in IRU Swaps

In late 2001 through early 2002, Qwest conducted a study to determine how to use the international capacity it had purchased in IRU swaps. The study concluded that Qwest could possibly use or resell only one-third of the capacity it had purchased in the swaps. The remaining two-thirds of the capacity purchased was not needed by Qwest, could not be resold, and was, therefore, worthless.

Accounting for Swap Transactions

In accounting for swaps, Qwest recognized large amounts of revenue immediately, which was an aggressive method relative to the rest of the telecommunications industry. Yet, Qwest capitalized its costs related to purchasing capacity from others as long-term assets that were amortized over the 20–25 year term of the IRU.

During 2000 and 2001, the frequency, dollar amount, and number of swap transactions grew as Qwest tried to meet its aggressive revenue targets in the face of declining demand for fiber-optic assets. Internally, some Qwest managers and employees referred to these transactions using the acronym of “SLUTS,” which stood for simultaneous, legally unrelated transactions. In fact, most of Qwest’s swaps were completed as directed by members.

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214 SEC v. Qwest, 31.
216 SEC v. Qwest, 31.
217 SEC v. Qwest, 30.
218 SEC v. Qwest, 24.
of senior management in the waning days and hours of each quarter in desperate attempts to achieve previously stated revenue targets.\textsuperscript{219}

Pressure from senior management even motivated employees to backdate contracts to falsely demonstrate that a contract was “completed” by the end of the quarter. For example, the company recorded revenue of $69.8 million in the first quarter of 2001 on a swap transaction with Cable & Wireless that had not closed until after the quarter (on April 12, 2001) by backdating the contract to March 30, 2001. In another example of backdating, in the third quarter of 2001, Qwest recognized $85.5 million of revenue on the sale of IRU capacity in a swap with Enron. The parties’ agreements, which are dated September 30, 2001, were not executed until October 1, 2001, after the close of the quarter.\textsuperscript{220}

**Case Questions**

1. Please describe why the recognition of revenue for IRU swaps for fiber-optic assets that are not actually needed by Qwest is inappropriate under GAAP. As an auditor, what type of evidence would allow you to determine whether the recognition of revenue would be appropriate under GAAP?

2. Consider Paragraph #63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Please identify one relevant financial statement assertion related to the revenue account that is impacted by an IRU swap. Why is it relevant?

3. Please consult Paragraph #84 of PCAOB Auditing Standard No. 2. The paragraph states that “the auditor should clearly link individual controls with the significant accounts and assertions to which they relate.” For the assertion identified in Question #2, please identify a specific internal control activity that would help to prevent or detect a misstatement related to the recognition of revenue for IRU swaps.

4. Consider Paragraph #25 of PCAOB Auditing Standard No. 2. Please discuss an internal control procedure that would help to prevent, detect, or deter the practice of “backdating” contracts to recognize revenue prematurely?

\textsuperscript{219} SEC v. Qwest, 24.

\textsuperscript{220} SEC v. Qwest, 28–29.
Case 4.3

Enron: A Focus on Revenue Recognition

Synopsis

In its 2000 Annual Report, Enron prided itself on having “metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people.”221 Enron’s strategy seemed to pay off; in 2000, it was the seventh largest company on the Fortune 500, with assets of $65 billion and sales revenues of $100 billion.222 From 1996 to 2000, its revenues had increased by more than 750 percent and 65 percent per year, which was unprecedented in any industry.223 Yet, just a year later, Enron filed for bankruptcy, and billions of shareholder dollars and retirement savings were lost.

In 2002, Enron’s auditor Arthur Andersen LLP, one of the five largest international public accounting firms, was convicted of obstruction of justice in connection with shredding documents related to the Enron audit. And although this conviction was overturned in 2005 by the United States Supreme Court, Andersen’s decision to destroy evidence cast suspicion on whether Andersen was trying to cover up any guilt related to a failure to perform its professional responsibilities.

Background

Enron was created in 1985 by the merger of two gas pipeline companies: Houston Natural Gas and InterNorth. Enron’s mission was to become the leading natural-gas pipeline company in North America. As it adapted to changes

in the natural gas industry, Enron changed its mission, expanding into natural gas trading and financing and into other markets, such as electricity and other commodity markets.

In the process, Enron made significant changes to several of its accounting procedures. For example, Enron began using mark-to-market (MTM) accounting for its trading business. Firms in the financial services industry typically used MTM to value their trading portfolios. That is, every day they adjusted the value of their portfolio according to its current value in the market. Enron was the first company outside the financial services industry to use MTM accounting.

**Enron’s Use of Mark-to-Market Accounting**

In 1992, the SEC’s chief accountant, Walter Scheutz, granted Enron permission to use MTM during the first quarter of its fiscal year ended December 31, 1992. However, he also indicated that MTM could be used only in Enron’s natural gas trading business. Enron’s CFO, Jack Tompkin, wrote back to Scheutz informing him that “Enron has changed its method of accounting for its energy-related price risk management activities effective January 1, 1991 … the cumulative effect of initial adoption of mark-to-market accounting, as well as the impact upon 1991 earnings is not material.”

For some time, there has been debate about whether MTM should be used for assets that are actively traded. For certain assets, like stock portfolios, an active trading market exists and the determination of value is straightforward. However, the value of natural gas contracts were harder to assess as they often required complex valuation formulas with multiple assumptions for the formulas’ variables, such as interest rates, customers, costs, and prices. These assumptions have a major impact on value and are related to very long time periods, in some cases, as long as 20

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Early Application of MTM Accounting: Sithe Energies Agreement

One of the earliest contracts for which Enron employed MTM accounting was an agreement for Enron to supply Sithe Energies with 195 million cubic feet of gas per day for 20 years for a plant that Sithe was going to build in New York. The estimated value of the gas to be supplied was $3.5 to $4 billion. Interestingly, by using MTM, Enron was able to book profits from the contract even before the plant started operating.228

Prior to the use of MTM, Enron would have recognized the actual costs of supplying the gas and the actual revenues received from selling the gas in each time period. Using MTM, at the moment a long-term contract was signed, the present value of the stream of future inflows under the contract was recognized as revenues and the present value of the expected costs of fulfilling the contract were expensed.229 Changes in value were recognized as additional income or loss (with a corresponding change to the relevant balance sheet account) in subsequent periods.230

Enron’s Expanded Use of MTM Accounting

Although the SEC had initially given approval for Enron to use MTM in the accounting of natural gas futures contracts, Enron quietly began using MTM for electric power contracts and trades as well.231 In one example, Enron signed a 15-year, $1.3 billion contract to supply electricity to Eli Lilly. Enron calculated the present value of the contract as more than half a billion dollars and recognized this amount as revenue. It also reported estimates for the

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costs associated with servicing the contract. Interestingly, at the time of this contract, Indiana had not yet deregulated electricity. Thus, Enron needed to predict when Indiana would deregulate, as well as the impact of the deregulation on the contract valuation.\footnote{Paul M. Healy and Krishna Palepu, “The Fall of Enron,” \textit{Journal of Economic Perspectives}, Vol. 17, No. 2, Spring 2003, p. 10.}

Enron also extended MTM accounting to other business lines. In another example, Enron signed a 20-year agreement with Blockbuster Video in July 2000 to introduce entertainment on-demand. Enron set up pilot projects in Portland, Seattle, and Salt Lake City to store the entertainment and then distribute it over its broadband network. Based on these pilot projects, Enron recognized estimated profits of more than $110 million for the Blockbuster deal, although the technical viability and market demand were difficult to predict in these initial, pilot stages.\footnote{Paul M. Healy and Krishna Palepu, “The Fall of Enron,” \textit{Journal of Economic Perspectives}, Vol. 17, No. 2, Spring 2003, p. 10.} Canceled in March 2001, the Blockbuster deal never reached past the initial, pilot stages.

**Case Questions**

1. Please consider the Sithe Energies contract described in the case. Does the use of MTM accounting violate the revenue recognition principle of GAAP? Why or why not?

2. Please refer to Paragraph #72 of PCAOB Auditing Standard No. 2. As an auditor, would you consider the natural gas trading revenue recognized using MTM accounting as having a “differing level” of inherent risk than other types of revenue recognized by Enron? Why or why not?

3. Refer to Paragraph #74 of PCAOB Auditing Standard No. 2. Can you identify one point in the natural gas revenue recognition process where a member of Enron’s management team might be able to perpetrate a fraudulent misstatement related to one of the relevant financial statement assertions? Please identify the assertion and use the case information to provide an example for your answer.

4. Please refer to Paragraphs #84–85 of PCAOB Auditing Standard No. 2. Identify one specific control activity that could be designed to prevent the misstatement (that you identified in Question #3) from occurring. Next, identify one specific control procedure that could be designed to detect the misstatement (that you identified in
Question #3) from occurring.
Case 4.4

Waste Management: A Focus on Capitalization of Expenses

Synopsis

In February 1998, Waste Management announced that it was restating the financial statements it had issued for the years 1993 through 1996. In its restatement, Waste Management said that it had materially overstated its reported pretax earnings by $1.43 billion. After the announcement, the company’s stock dropped by more than 33 percent and shareholders lost over $6 billion.

The SEC brought charges against the company’s founder Dean Buntrock and five other former top officers. The charges alleged that management had made repeated changes to depreciation-related estimates to reduce expenses and had employed several improper accounting practices related to capitalization policies, also designed to reduce expenses.234

Capitalization of Landfill Costs and Other Expenses

Under Generally Accepted Accounting Principles (GAAP), a cost can be capitalized if it provides economic benefits to be used or consumed in future operations. A company is required to write off, as a current period expense, any deferred costs at the time the company learns that the underlying assets have either been impaired or abandoned. Any costs to repair or return property to its original condition are required to be expensed when incurred. Finally, interest can be capitalized as part of the cost of acquiring assets for the period of time that it takes to put the asset in the condition required for its intended use. However, GAAP requires that the capitalization of interest must cease once the asset has become substantially ready for its intended use.

Capitalization of Landfill Permitting Costs235

234 SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).

Waste Management capitalized the costs related to obtaining the required permits to develop and expand their many landfills. It also capitalized interest on landfill construction costs, as well as costs related to systems development at their landfills.

As part of its normal business operations, Waste Management allocated substantial resources toward the development of new landfills and the expansion of existing landfills. A significant part of the landfill development and expansion costs related to the process of obtaining required permits from the appropriate government authorities. Over the years, the companies faced increased difficulty in obtaining the required landfill permits, and often was faced with having invested significantly in projects that had to be abandoned or were materially impaired when the required permits could not be obtained.

The company routinely capitalized the costs related to obtaining the required permits, so it could defer recording expenses related to that landfills until they were put into productive use. However, instead of writing off the costs related to impaired and/or abandoned landfill projects and disclosing the impact of such write-offs, management only disclosed in its Form 10-K filed with the SEC the risk of future write-offs related to such projects.

The management team of Waste Management also engaged in transferring the costs of unsuccessful efforts to obtain permits to other different sites that had received permits or other sites for which they were still seeking permits. In effect, they were commingling impaired or abandoned landfill project costs with the costs of a permitted site (a practice known as “basketing,” which did not comply with GAAP). In addition to basketing, the company also engaged in transferring unamortized costs from landfill facilities that had closed earlier than expected to other facilities that were still in operation (a practice known as “bundling,” which also did not comply with GAAP). Management never disclosed the use of bundling or basketing in its form 10-K.

In 1994, after its auditor Arthur Andersen discovered these practices, management agreed to write off $40 million related to “dead” projects over a span of ten years, and also promised to write off future impairments and abandonments in a prompt manner. However, during 1994, 1995, 1996, and 1997, management effectively “buried” the write-offs related to abandoned and impaired projects by “netting” them against other gains, as opposed to identifying the costs separately as it had promised Andersen.

**Capitalization of Interest on Landfill Construction Costs**

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235a Ibid.
In accordance with GAAP, Waste Management was able to capitalize interest related to landfill development because of the relatively long period of time required to obtain permits, construct the landfill, and ultimately prepare it to receive waste. However, Waste Management utilized a method, referred to as the “net book value (NBV) method” that essentially enabled it to avoid GAAP’s requirement that interest capitalization cease once the asset became substantially ready for its intended use. Waste Management’s auditor, Arthur Andersen, advised the company from its first use of the NBV method (in 1989), that this method did not conform with GAAP.

Corporate controller Thomas Hau allegedly admitted that the method was “technically inconsistent with FAS Statement No. 34 [the controlling GAAP pronouncement] because it included interest [capitalization] related to cells of landfills that were receiving waste.” Yet, the company wrote in the footnotes to its financial statements that “[i]nterest has been capitalized on significant landfills, trash-to-energy plants and other projects under development in accordance with FAS No. 34.”

Ultimately, the company agreed to utilize a new method that conformed to GAAP, beginning January 1, 1994. Corporate controller Thomas Hau and CFO James Koenig allegedly determined that the new GAAP method would result in an increased annual interest expense of about $25 million, and therefore, they chose to phase in the new method over a period of three years, beginning in 1995. However, the company was still utilizing the NBV method for interest capitalization as of 1997.

**Capitalization of Other Costs**

The company also chose to capitalize other costs, such as systems development costs, rather than record them as expenses in the period in which they were incurred. In fact, they used excessive amortization periods (10- and 20-year periods for the two largest systems) that did not recognize the impact of technological obsolescence on the useful lives of the underlying systems.

The company’s auditor Arthur Andersen proposed several adjusting journal entries to write off the improperly deferred systems development costs. Andersen also repeatedly advised management to shorten the amortization periods. In 1994, management finally agreed to shorten the amortization periods and to write off financial statement misstatements resulting from improperly capitalized systems costs over a period of five years. During 1995 the company changed the amortization periods and wrote off improperly capitalized systems costs by “netting” them

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235b Ibid.
against other gains.

**Case Questions**

1. Please describe why “bASKETing” and “bUNDLING” are not appropriate under GAAP. As an auditor, what type of evidence would allow you to detect whether your client was engaging in “bASKETing” or “bUNDLING”?

2. Describe why “netting” would be effective for Waste Management’s management team when trying to cover up their fraud. As an auditor, what type of evidence would allow you to detect whether your client was engaged in this type of practice that is designed to mask fraudulent behavior?

3. As an auditor, what type of evidence would you want to examine to determine whether Waste Management was inappropriately capitalizing interest expense and recording the amount as an addition to a fixed assets account?

4. Please consult Paragraph #60 and Paragraphs 68–70 of PCAOB Auditing Standard No. 2. What is the most relevant financial statement assertion(s) about which financial statement account(s) related to the improper capitalization practices of Waste Management? Why?
Case 4.5

Waste Management: A Focus on Depreciation and Amortization

Synopsis

In February 1998, Waste Management announced that it was restating the financial statements it had issued for the years 1993 through 1996. In its restatement, Waste Management said that it had materially overstated its reported pretax earnings by $1.43 billion. After the announcement, the company’s stock dropped by more than 33 percent and shareholders lost over $6 billion.

The SEC brought charges against the company’s founder Dean Buntrock and five other former top officers. The charges alleged that management had made repeated changes to depreciation-related estimates to reduce expenses and had employed several improper accounting practices related to capitalization policies, also designed to reduce expenses.\textsuperscript{236}

Fixed Asset Process

The major fixed assets of Waste Management’s North American business consisted of garbage trucks, containers, and equipment, which amounted to approximately $6 billion in assets. The second largest asset of the company (after vehicles, containers, and equipment) was land, in the form of the more than one hundred fully operational landfills that the company both owned and operated. Under GAAP, depreciation expense is determined by allocating the historical cost of tangible capital assets (less the salvage value), over the estimated useful life of the assets.

Unsupported Changes to the Estimated Useful Lives of Assets

From 1988 through 1996, management made numerous unsupported changes to the estimated useful lives and/or salvage values of one or more categories of vehicles, containers, or equipment. Such changes had the effect of

\textsuperscript{236} SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).
reducing the amount of depreciation expense recorded in a particular period. In addition, such changes were recorded as top-side adjustments, at the corporate level (detached from the operating unit level). Most often, the entries were made during the fourth quarter, and then improperly applied cumulatively from the beginning of the year. Management did not appear to disclose the changes or their impact on profitability to their investors.237

In a letter to the management team dated May 29, 1992, Arthur Andersen’s team wrote, “[i]n each of the past five years the Company added a new consolidating entry in the fourth quarter to increase salvage value and/or useful life of its trucks, machinery, equipment, or containers.” Andersen recommended that the company conduct a “comprehensive, one-time study to evaluate the proper level of WMNA’s salvage value and useful lives,” and then send these adjustments to the respective WMNA groups. Top management allegedly continued to change depreciation estimates at headquarters, however.

Carrying Impaired Land at Cost

Because of the nature of landfills, GAAP also requires that a company compare a landfill’s cost to its anticipated salvage value, with the difference depreciated over the estimated useful life of the landfill. Waste Management disclosed in the footnotes to the financial statements in its annual reports that “[d]isposal sites are carried at cost and to the extent this exceeds end use realizable value, such excess is amortized over the estimated life of the disposal site.” However, in reality, Waste Management allegedly carried almost all of its landfills on the balance sheet at cost.238

In response to this treatment of landfills on the balance sheet, after its 1988 audit, Andersen issued a management letter to the Board of Directors recommending that the company conduct a “site by site analysis of its landfills to compare recorded land values with its anticipated net realizable value based on end use.” Andersen further instructed that any excess needed to be amortized over the “active site life” of the landfill. Andersen made similar demands after its audit in 1994. Management never conducted such a study and they also failed to reduce the carrying values of overvalued land, despite their commitment to do so after Andersen’s audit in 1994.


238 Ibid.
**Case Questions**

1. Under what circumstances is a company allowed to change the useful life and salvage value of its fixed assets under GAAP? As an auditor, what type of evidence would you want to examine to determine whether Waste Management’s decision to change the useful life and salvage value of its assets was appropriate under GAAP?

2. Please consult Paragraph #60 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. What is the most relevant financial statement assertion(s) about which financial statement account(s) related to the treatment of depreciation expense on fixed assets at Waste Management?

3. If you were auditing Waste Management in 1995 and you discovered that neither the Board of Directors nor the Management Team conducted a “site by site analysis” of the landfills that you had recommended the year before, what action, if any, would you take? Why?

4. Please consult Paragraph #84 of PCAOB Auditing Standard No. 2. The paragraph states that “the auditor should clearly link individual controls with the significant accounts and assertions to which they relate.” For the assertion identified in Question #2, please identify a specific internal control activity that would help to prevent or detect a misstatement related to depreciation expense at Waste Management.
Case 4.6

WorldCom: A Focus on Line Cost Accruals

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 that it had filed for bankruptcy. It was later revealed that WorldCom had likely 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.

Line Cost Expenses

WorldCom generally maintained its own lines for local service in heavily populated urban areas. However, it relied on non-WorldCom networks to complete most residential and commercial calls outside of these urban areas and paid the owners of the networks to use their services. For example, a call from a WorldCom customer in Boston to Rome might start on a local (Boston) phone company’s line, flow to WorldCom’s own network, and then get passed to an Italian phone company to be completed. In this example, WorldCom would have to pay both the local Boston phone company and the Italian provider for the use of their services.\(^{239}\) The costs associated with carrying a voice call or data transmission from its starting point to its ending point were called line cost expenses.

Line cost expenses were WorldCom’s largest single expense. They accounted for approximately half of the company’s total expenses from 1999 to 2001. WorldCom regularly discussed its line cost expenses in public disclosures, emphasizing, in particular, its line cost E/R ratio, the ratio of line cost expense to revenue.\(^{240}\)

GAAP for Line Costs

Under Generally Accepted Accounting Principles (GAAP), WorldCom was required to estimate its line costs each

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\(^{239}\) Board of Directors’ Special Investigative Committee Report, June 9, 2003, 58.

\(^{240}\) Ibid., 58–59.
month and to expense the estimated cost immediately, even though many of these costs would be paid at a later date.

To reflect an estimate of amounts that had not yet been paid, WorldCom would set up a liability account, known as an accrual, on its balance sheet. As the bills arrived from its outside parties, sometimes many months later, WorldCom would pay them and reduce the previously established accruals accordingly.\textsuperscript{241}

Because accruals are estimates, a company was required under GAAP to reevaluate them periodically to see if they were stated at appropriate levels. If charges from service providers were lower than estimated, an accrual was “released.” The amount of the release was set off against the reported line cost expenses in the period when the release occurred. For example, if an accrual of $500 million was established in the first quarter and $25 million of that amount was deemed excess or unnecessary in the second quarter, then $25 million should be released in that second quarter and, thus, result in reducing reported line cost expenses by $25 million.\textsuperscript{242}

**WorldCom’s Line Cost Releases**

Beginning in the second quarter of 1999, management started ordering several releases of line cost accruals, often without any underlying analysis to support the releases. When requests were met with resistance, management made the adjustments themselves. For example, in the second quarter of 2000, David Myers, a CPA who served as senior vice president and controller of WorldCom, requested that UUNET (a largely autonomous WorldCom subsidiary at the time) release $50 million in line cost accruals. UUNET’s acting CFO David Schneeman asked that Myers explain the reasoning for the requested release, but Myers insisted that Schneeman book the entry without an explanation. When Schneeman refused, Myers wrote to him in an e-mail: “I guess the only way I am going to get this booked is to fly to DC and book it myself. Book it right now, I can’t wait another minute.” After Schneeman refused again, Betty Vinson in General Accounting allegedly completed Myers’ request by making a “top-side” corporate-level adjusting journal entry releasing $50 million in UUNET accruals.\textsuperscript{243}

In 2000, senior members of WorldCom’s corporate finance organization allegedly directed a number of similar releases from accruals established for other reasons to offset domestic line cost expenses. For example, in the second

\textsuperscript{241} Ibid., 62–63.

\textsuperscript{242} Ibid., 63–64.

\textsuperscript{243} Ibid., 83.
quarter of 2000, Senior Vice President and Controller David Myers asked Charles Wasserott, Director of Domestic Telco Accounting, to release $255 million in domestic line cost accruals to reduce domestic line cost expenses. Wasserott refused to release such a large amount. It later emerged that the entire $255 million used to reduce line cost expenses came, instead, from a release of a Mass Markets accrual related to WorldCom’s Selling General & Administrative expenses. 244

The largest of the releases of accruals from other areas to reduce line cost expenses occurred after the close of the third quarter of 2000. During this time, a number of entries were made to release various accruals that reduced domestic line cost expenses by $828 million. 245

In addition to allegations that WorldCom’s management released line cost accruals without proper support for doing so and released accruals that had been established for other purposes, there were also allegations that management often did not release certain line costs in the period in which they were identified. Rather, certain line cost accruals were kept as “rainy day” funds that could be released when management needed to improve reported results. 246

Case Questions

1. Describe what is meant by “releasing” line costs. If you were working as an accountant for WorldCom and there was a legitimate basis to “release” certain line costs, what is the journal entry that would be required to “release” a line cost?

2. Please refer to Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Identify one relevant financial statement assertion related to the line cost expenses account. Why is it relevant? Next, identify one relevant financial statement assertion related to the accrued line cost liability account. Why is it relevant?

3. As an auditor at WorldCom, what type of evidence would you want to examine to determine whether a company was inappropriately “releasing” line costs?

4. Please refer to Paragraph #25 of PCAOB Auditing Standard No. 2. This paragraph requires management to

244 Ibid., 87–88.

245 Ibid., 88–89.

246 Ibid., 10.
design and implement controls to prevent, deter, and detect fraud. For WorldCom’s line cost financial reporting process, please discuss an internal control activity that would help to prevent, detect, or deter fraud related to the “releasing” of line costs.
Case 4.7

Sunbeam: A Focus on Restructuring Reserves

Synopsis

In April 1996, Sunbeam named Albert J. Dunlap as its CEO and Chairman. Formerly with Scott Paper Co., Dunlap was known as a turnaround specialist and was even nicknamed “Chainsaw Al” because of the cost-cutting measures he typically employed. Almost immediately, Dunlap began replacing nearly all of the upper management team and led the company into an aggressive corporate restructuring that included the elimination of half of its 12,000 employees and the elimination of 87 percent of Sunbeam’s products.

Unfortunately, in May 1998, Sunbeam disappointed investors with its announcement that it had earned a worse-than-expected loss of $44.6 million in the first quarter of 1998.²⁴⁷ CEO and Chairman Dunlap was fired in June 1998. In October 1998, Sunbeam announced that it would need to restate its financial statements for 1996, 1997 and 1998.²⁴⁸

Background

Included in Sunbeam’s fraudulent accounting was its creation of accounting reserves that were aimed at lowering Sunbeam’s reported 1996 net income so as to make the company’s 1997 net income appear better by comparison. In addition, the reserves served as a “cookie jar” that management could dip into at its discretion to increase income in 1997, thereby creating a picture of a rapid turnaround.²⁴⁹ Further, Sunbeam’s restructuring costs included items that benefited future activities, a violation of GAAP, which did not allow the inclusion of restructuring costs that


Sunbeam’s Restructuring Charges

Associated with its operational restructuring, Sunbeam’s 1996 results included a pretax charge to earnings of $337.6 million, which was allocated as follows:

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restructuring, Impairment, and Other Costs</td>
<td>$154.9 million</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>$92.3 million</td>
</tr>
<tr>
<td>Selling, General, and Administrative (SG&amp;A)</td>
<td>$42.5 million</td>
</tr>
<tr>
<td>Estimated Loss from Discontinued Operations</td>
<td>$47.9 million</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$337.6 million</strong></td>
</tr>
</tbody>
</table>

Restructuring, Impairment, and Other Costs

The “Restructuring, Impairment, and Other Costs” category included the following cash items: severance and other employee costs ($43.0 million), lease obligations and other exit costs associated with facility closures ($12.6 million), back office outsourcing start-up costs, and other costs related to the implementation of the restructuring and growth plan ($7.5 million). Noncash items in this category ($91.8 million) were related to asset write-downs for disposals of excess facilities and equipment, and noncore product lines; write-offs of redundant computer systems from the administrative back-office consolidations and outsourcing initiatives; and intangible, packaging, and other asset write-downs related to exited product lines and SKU reductions.

Importantly, this amount also included approximately $18.7 million of items that benefited future activities, for example, costs of redesigning product packaging, costs of relocating employees and equipment, and certain consulting fees. Inclusion of these items was not allowed under GAAP because these costs related to activities that benefited future periods.

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251 1996 10K filing to SEC. Also see 1997 10K SEC filing, Note 8 (“Restructuring, Impairment, and Other Costs”).

Cost of Goods Sold, SG&A, and Estimated Loss from Discontinued Operations

As part of its operational restructuring, Sunbeam sold the inventory of its eliminated products to liquidators at a substantial discount. As such, the Cost of Goods Sold portion of the restructuring charge related principally to inventory write-downs and costs of inventory liquidation programs.

The SG&A portion of the restructuring charge related principally to increases in environmental, litigation, and other reserves. The litigation reserve was created for a lawsuit alleging Sunbeam’s potential obligation to cover a portion of the cleanup costs for a hazardous waste site. To establish a litigation reserve under GAAP, management must determine that the reserved amount reflects a loss that is probable and able to be reasonably estimated. However, Sunbeam allegedly failed to take sufficient steps to determine what reserve amount would have been appropriate under GAAP. Finally, the estimated loss from the discontinued operations portion of the restructuring reserve related to the divestiture of the company’s furniture business.

Using Excess Reserves to Offset Current Expenses

Initially, during the first quarter of 1997, Sunbeam used $4.3 million of these restructuring reserves to offset against costs incurred in that period. Essentially, this reserve was set up as a “cookie jar” in 1996 that allowed Sunbeam’s 1997 income to improve by approximately 13 percent. Sunbeam failed to disclose this “infrequent item” in its quarterly filing. In the second quarter of 1997, Sunbeam offset $8.2 million in second quarter costs against the restructuring and other reserves created at year-end 1996, without making the appropriate disclosures. It made similar offsets of current period expenses in the third and fourth quarters of 1997: $2.9 million and $1.5 million, respectively.

Final Restatement of Restructuring Charge

In November 1998, Sunbeam ultimately restated the pretax restructuring charge from $337.6 million to $239.2 million.

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254 1996 10K filed with the SEC.
million, which was allocated as follows:256

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restructuring, Impairment, and Other Costs</td>
<td>$110.1 million</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>$60.8 million</td>
</tr>
<tr>
<td>Selling, General, and Administrative (SG&amp;A)</td>
<td>$10.1 million</td>
</tr>
<tr>
<td>Estimated Loss from Discontinued Operations</td>
<td>$58.2 million</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$239.2 million</strong></td>
</tr>
</tbody>
</table>

**Restructuring, Impairment, and Other Costs**

Restructuring, Impairment, and Other Costs was restated as follows: severance and other employee costs of $24.7 million, lease obligations and other exit costs associated with facility closures of $16.7 million. Noncash items—related to asset write-downs for disposals of excess facilities, and equipment and noncore product lines; write-offs of redundant computer systems from the administrative back-office consolidations and outsourcing initiatives; and intangible, packaging, and other asset write-downs related to exited product lines and SKU reductions—totaled $68.7 million.257

**Cost of Goods Sold, SG&A, and Estimated Loss from Discontinued Operations**

Contributing to the company’s need to restate its Cost of Goods Sold expense related to restructuring stemmed from the fact that, in calculating its estimate for year-end inventory of household products, management failed to distinguish excess and obsolete inventory from inventory that was part of its continuing product lines. Thus, the value of Sunbeam’s inventory from its continuing household product lines had been understated by $2.1 million on its balance sheet. In addition, its restatement to its SG&A included a revision of a $12 million litigation reserve that initially was improperly overstated by at least $6 million.258

**Case Questions**

1. Please explain what is meant by a restructuring reserve. As an auditor, what type of evidence would you want to

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256 Amended 1997 10K filed with the SEC.

257 Amended 1997 10K filed with the SEC.

examine to determine whether a company was inappropriately accounting for its restructuring reserve?

2. Refer to Paragraph #72 of PCAOB Auditing Standard No. 2. As an auditor, would you consider the different components of the restructuring reserve as having a “differing level” of inherent risk? Why or why not?

3. Please refer to Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Identify one relevant financial statement assertion related to the restructuring reserve account? Why is it relevant?

4. This case describes a situation where a company overstated its recorded expenses in 1996 (as compared to understating recorded expenses). Why would a company choose to overstate its expenses and understate its net income?
Case 4.8

Sunbeam: A Focus on Revenue Recognition

Synopsis

In April 1996, Sunbeam named Albert J. Dunlap as its CEO and Chairman. Formerly with Scott Paper Co., Dunlap was known as a turnaround specialist and was even nicknamed “Chainsaw Al” because of the cost-cutting measures he typically employed. Almost immediately, Dunlap began replacing nearly all of the upper management team and led the company into an aggressive corporate restructuring that included the elimination of half of its 12,000 employees and the elimination of 87 percent of Sunbeam’s products.

Unfortunately, in May 1998, Sunbeam disappointed investors with its announcement that it had earned a worse-than-expected loss of $44.6 million in the first quarter of 1998. 259 CEO and Chairman Dunlap was fired in June 1998. In October 1998, Sunbeam announced that it would need to restate its financial statements for 1996, 1997 and 1998. 260

Sunbeam’s Customer Discounts and Other Incentives and Sales to Distributors

Under GAAP, sales revenue can only be recognized if the buyer assumes the risks and rewards of ownership of merchandise, for example, the risk of damage or physical loss. A sale with a right of return can be recognized as revenue only if the seller takes a reserve against possible future returns. The size of this reserve must be based on the company’s history with returns; the sales revenue may not be recorded if no such history exists.

Beginning with the first quarter of 1997, Sunbeam began offering its customers discounts and other incentives if they placed their orders in the current period, rather than holding off until the next period. Sunbeam did not disclose this practice of accelerating expected sales from later periods in their financial statements, however. In the other


quarters of 1997, Sunbeam also allegedly relied on additional price discounting and other incentives in an attempt to accelerate the recognition of revenue from future periods.\textsuperscript{261}

One example of a special arrangement with a customer took place at the end of March 1997, just before the first quarter closed. Sunbeam recognized $1.5 million in revenue and contributed $400,000 toward net income from the sale of barbecue grills to a wholesaler. The contract with the wholesaler provided that the wholesaler could return all of the merchandise, with Sunbeam paying all costs of shipment and storage, if it was unable to sell it. In fact, the wholesaler wound up returning all of the grills to Sunbeam during the third quarter of 1997, and the wholesaler incurred no expenses in the transaction.\textsuperscript{262}

\textbf{Sales to Distributors}

In December 1997, Sunbeam devised a “distributor program” that would help improve the company’s sales. The program was designed to help Sunbeam accelerate the recognition of sales revenue for merchandise it placed with distributors in advance of actual retail demand. Sunbeam allegedly used favorable payment terms, discounts, guaranteed mark-ups, and, consistently, the right to return unsold product as incentives for distributors to participate in the program.

The sales under the distributor program represented a new distribution channel for the company. Therefore, Sunbeam was unable to set an appropriate level of reserves for any returns.\textsuperscript{263}

\textbf{Bill and Hold Sales}

In the second quarter of 1997, Sunbeam recognized $14 million in sales revenue from bill and hold sales. By the fourth quarter, Sunbeam had recognized $29 million in revenues and contributed an additional $4.5 million toward net income in bill and hold sales after it began promoting its bill-and-hold program. In all, bill and hold sales contributed to 10 percent of the fourth quarter’s revenue.\textsuperscript{264}

At year-end 1997, Sunbeam disclosed in its annual filing to the SEC that “the amount of [the] bill and hold sales at December 29, 1997 was approximately 3 percent of consolidated revenues.” It did not disclose the extent to which the bill and hold sales had been booked in the final quarter.265

**Revenue Recognition Criteria for Bill and Hold Sales**

The SEC had stipulated that the following criteria must be met for revenue to be recognized in bill and hold transactions:266

- The risks of ownership must have passed to the buyer.
- The buyer must have made a fixed commitment to purchase the goods.
- The buyer must request that the transaction be on a bill and hold basis, and must have a substantial business purpose for this request.
- There must be a fixed schedule for delivery of the goods.
- The seller must not have retained any specific performance obligations such that the earning process is not complete.
- The ordered goods must be segregated from the seller’s inventory.
- The goods must be complete and ready for shipment.

**Characteristics of Sunbeam’s Bill and Hold Sales**

The SEC found that Sunbeam’s bill and hold sales were not requested by Sunbeam’s customers and served no business purpose other than to accelerate revenue recognition by Sunbeam. Sunbeam’s bill and hold sales were typically accompanied by financial incentives being offered to customers, such as discounted pricing, to encourage the sale to occur long before the customer actually needed the goods. Sunbeam would then typically hold the product until delivery was requested by the customer. Sunbeam also paid the costs of storage, shipment, and insurance related to the products. In addition, Sunbeam’s customers had the right to return the unsold product.267

**Restatement of Revenues**


266 Staff Accounting Bulletin No. 101.

In 1998, Sunbeam restated its revenues for 1997 from $1,168,182 to $1,073,090. In an amended filing of its 10-K to the SEC, management wrote: “Upon examination, it was determined certain revenue was improperly recognized (principally “bill and hold” and guaranteed sales transactions)…” The company had reversed all “bill and hold” sales, which amounted to $29 million in 1997, and about $36 million in guaranteed or consignment sales, whose liberal return policies made the recognition of their revenue improper.

**Case Questions**

1. Please consider Paragraphs #61–65 of PCAOB Auditing Standard No. 2. Do you believe that revenue derived from bill and hold sales, and revenue derived from sales to customers receiving special discounts should be evaluated differently when considering the design and operating effectiveness of the internal control system? Why or why not?

2. As an auditor, what type of evidence would you want to examine to determine whether Sunbeam was inappropriately recording revenue from special discount sales?

3. Please consider Paragraph #96 of PCAOB Auditing Standard No. 2. Do you believe that the control activity described would be helpful to detect the fraudulent sales recorded by Sunbeam to customers receiving special discounts? Why?

4. Consider Paragraphs #55–59 of PCAOB Auditing Standard No. 2. Identify one action that the Audit Committee of Sunbeam could have taken to help insure that a revenue recognition fraud would not have occurred?

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268 Amended 1997 10K filing to SEC.

Case 4.9

Qwest: A Focus on Revenue Recognition

Synopsis

When Joseph Nacchio became Qwest’s CEO in January 1997, its existing strategy to construct a fiber-optic network across major cities in the United States began to shift toward communications services as well. By the time it released earnings in 1998, Nacchio proclaimed Qwest’s successful transition from a network construction company to a communications services provider. “We successfully transitioned Qwest … into a leading Internet protocol-based multimedia company focused on the convergence of data, video, and voice services.”

During 1999 and 2000, Qwest consistently met its aggressive revenue targets and became a darling to its investors. Yet, it was later uncovered that Qwest had fraudulently recognized $3.8 billion in revenues and fraudulently excluded $231 million in expenses. When the company announced its intention to restate revenues, its stock price plunged to a low of $1.11 per share in August 2002, from a high of $55 per share in July 2000. During this period, its market capitalization declined by 98 percent, from a high of $91 billion to a low of $1.9 billion.

Background

Included within the $3.8 billion of revenues that were fraudulently recognized by Qwest were prematurely recognized revenues from sales of IRUs for its network. Qwest treated IRU sales as sales-type leases, which allow a seller to treat a lease transaction as a sale of an asset with complete, upfront revenue recognition. According to GAAP, this type of upfront revenue recognition required: (1) completion of the earnings process; (2) that the assets sold remain fixed and unchanged; (3) full transfer of ownership, with no continuing involvement by the seller; and (4) an assessment of fair market value of the revenue components. In addition, as part of the completion of the earnings process, the assets being sold had to be explicitly and specifically identified.

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271 SEC v. Qwest, 1–2.
Portability

Qwest generally allowed customers of IRUs the ability to port, or exchange, IRUs purchased for other IRUs. By mid-2001, Qwest had ported at least 10 percent of assets sold as IRUs. Portability was not uncommon in the telecommunications industry, because companies needed the flexibility to change their network as demand changed.\(^{272}\)

However, because the practice of porting jeopardized Qwest’s ability to recognize revenue on IRUs upfront, Qwest salespeople would often grant its customers the right to port through secret side agreements or verbal assurances. For example, in the fourth quarter 2000, Qwest sold to Cable & Wireless $109 million of capacity in the United States (and recognized $108 million in upfront revenue) by providing a secret side agreement, which guaranteed that Cable & Wireless could exchange the specific capacity it purchased at a later date.\(^{273}\)

As another example, in the first quarter of 2001, Qwest sold IRU capacity to Global Crossing and recognized $102 million of upfront revenue, after it gave secret verbal assurances to Global Crossing that Qwest would agree to exchange the capacity when the IRU capacity that Global Crossing actually wanted became available.\(^{274}\)

Ownership Transfer

Qwest also had a significant continuing involvement with all IRUs sold in the form of ongoing administrative, operating, and maintenance activities. While Qwest’s IRU sales agreements generally provided for title transfer at the end of the lease term, conditions also existed that would require that the title remained with Qwest, in reality. In addition, there was significant uncertainty about whether the title would ever transfer in certain other situations.\(^{275}\)

Interestingly, there was no statutory title transfer system for IRUs that is comparable to what exists for real property. In addition, some of Qwest’s “right of way” agreements on the underlying IRUs actually expired prior to the end of the IRU terms. Further, some of the underlying IRU agreements (concerning IRUs that Qwest purchased from a third party, and then resold) did not allow Qwest to sublease its “rights of way” or did not provide title to

\(^{272}\) SEC v. Qwest, 20.

\(^{273}\) SEC v. Qwest, 26–27.

\(^{274}\) SEC v. Qwest, 26–27.

\(^{275}\) SEC v. Qwest, 22–23.
Qwest. Therefore, Qwest could not legally provide those rights to a third party.276

In some IRU contracts, Qwest specifically stated that the purchaser did not receive any ownership interest in the fiber. Similarly, in many contracts, Qwest prohibited the purchaser from assigning, selling, or transferring the fiber-optic capacity, without Qwest’s prior written consent. For example, on March 31, 2000, Qwest entered into a $9.6 million IRU transaction with Cable & Wireless in which Qwest included a clause preventing assignment, sale, or transfer without Qwest’s consent.277

Other Characteristics That Failed to Comply with GAAP

Qwest’s upfront revenue recognition of IRUs was also premature because Qwest routinely neglected to specify the assets it was selling. For example, in the first quarter ended March 31, 2001, Qwest sold $105 million of fiber-optic capacity to Global Crossing and recognized approximately $102 million in revenue on the sale. This was done despite the fact that the majority of the capacity was not specified in the contract by the end of the quarter. Rather, the contract exhibit intended to list the assets sold simply stated—”to be identified.” Further, Global Crossing and Qwest did not identify the geographic termination points of some of the capacity purchased by Qwest until June 2001, three months after Qwest recognized the revenue on the sale transaction.278 In addition, to circumvent problems on its network or to optimize the network’s efficiency, Qwest often moved IRUs previously sold, without customer consent, to different wavelengths and different routes as required. This process was known as grooming. During the third and fourth quarters of 2001, Qwest senior management knew of numerous IRUs that had been rerouted on different fibers. Qwest personnel informed senior management that the IRUs could not be restored to their original routes and advised senior management to reverse the revenue recognized from the IRU sales. Qwest senior management, however, rejected the employees’ recommendations. From the fourth quarter of 2001 through early 2002, Qwest continued to reroute IRU fibers as necessary.279

Independent Auditor Arthur Andersen and the SEC

276 SEC v. Qwest, 22.
277 SEC v. Qwest, 22.
278 SEC v. Qwest, 28.
279 SEC v. Qwest, 21.
The SEC brought charges against Mark Iwan, the Global Managing Partner at Arthur Andersen—the outside auditor for Qwest from 1999 to 2002—alleging that Iwan “unreasonably relied on management’s false representations that certain revenue recognition criteria for immediate revenue recognition on IRUs were met.” On account of these charges and others, the SEC ordered that Iwan was denied the privilege of appearing or practicing before the SEC as an accountant for a minimum of five years.

Specifically, the SEC found that Iwan learned that Qwest’s porting of capacity had risen to approximately 10 percent of the capacity sold by mid-2001. Although Iwan required Qwest to stop the practice of porting, he allegedly did not go back and ensure that the prior revenue recognition was in conformity with GAAP. Rather, Iwan exclusively relied on management’s representations that “Qwest had made no commitments to allow its customers to port capacity, that it was never Qwest’s intention to allow customers to port capacity, and that Qwest would not honor any future request to port capacity.”

The SEC also found that Iwan relied on representations from Qwest’s management and legal counsel that title did actually transfer on IRUs. In fact, Iwan allegedly knew by early 2000 that Qwest senior tax personnel believed there were “significant uncertainties as to whether title transfer would occur” and, thus, Qwest would treat IRUs as operating leases for tax purposes. Surprisingly, Iwan failed to reconcile Qwest’s position on title transfer for IRUs for income tax reporting purposes with its different position for financial reporting purposes under GAAP.

In 2001, Iwan required Qwest to obtain an outside legal opinion that Qwest had the ability to transfer title to the IRUs it sold over the past three years. Qwest provided to Iwan an abridged summary of the legal opinion that contained significant assumptions, qualifications, ambiguities, and limitations that were critical to evaluating whether Qwest met the ownership transfer requirements. Yet, Iwan continued to rely on the false representations of management and legal counsel in this regard.

**Case Questions**

1. Please describe why the upfront revenue recognition practices for sales of IRUs by Qwest was not appropriate

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under GAAP. Please be specific.

2. Based on your understanding of audit evidence, did Arthur Andersen rely on sufficient and competent audit evidence in its audit of the Qwest’s upfront revenue recognition processes? Why or why not?

3. Please consider Paragraph #63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Identify one relevant financial statement assertion related to revenue recognized for IRU sales by Qwest. Why is it relevant?

4. Consult Paragraph #84 of PCAOB Auditing Standard No. 2. For the assertion identified in Question #3, please identify a specific internal control activity that would help to prevent or detect a misstatement related to the practice of upfront revenue recognition of IRUs by Qwest.
Case 4.10

The Baptist Foundation of Arizona: A Focus on Presentation and Disclosure

Synopsis

The Baptist Foundation of Arizona (BFA), was organized as an Arizona non-profit organization primarily to help provide financial support for various Southern Baptist causes. Under William Crotts’s leadership, the foundation engaged in a major strategic shift in its operations. BFA began to invest heavily in the Arizona real estate market, and also accelerated its efforts to sell investment agreements and mortgage-backed securities to church members.

Two of BFA’s most significant affiliates were ALO and New Church Ventures. It was later revealed that BFA had set up these affiliates to facilitate the “sale” of its real estate investments at prices significantly above fair market value. In so doing, BFA’s management perpetrated a fraudulent scheme that cost at least 13,000 investors more than $590 million. In fact, Arizona Attorney General Janet Napolitano called the BFA collapse the largest bankruptcy of a religious nonprofit in the history of the United States. 283

Background

ALO and New Church Ventures had no employees of their own, and both organizations paid BFA substantial management fees to provide accounting, marketing, and administrative services. As a result, both ALO and New Church Ventures owed BFA significant amounts by the end of 1995. On an overall basis, BFA, New Church Ventures, and ALO had a combined negative net worth of $83.2 million at year-end 1995, $102.3 million at year-end 1996, and $124.0 million at year-end 1997. 284


In addition to its affiliates, BFA’s related parties included its subsidiaries, BFA senior management and their immediate families, as well as any former or current members of the Board of Directors. Yet, except for information provided about New Church Ventures in its 1994 financial statements, the transactions and balances due from the following individuals and companies were not disclosed as related parties in the financial statements for the years 1991 through 1994:

- Dwain Hoover, BFA Board member;
- Harold Friend, former BFA Board member;
- Jalma Hunsinger, owner of ALO, former BFA Board member, and New Church Ventures Board member;
- ALO and its subsidiaries and affiliates; and
- New Church Ventures and its subsidiaries and affiliates.\(^{285}\)


In the footnotes to BFA’s 1995 financial statements, rather than using their names, BFA described its related parties according to their titles or roles in the business. This practice made it far more difficult and time consuming for users to identify the true identity of the related parties. For example, BFA disclosed its related parties as follows: “Director A [Dwain Hoover] and his companies”; “Benefactor A [Harold Friend] and his companies”; and “Benefactor B [Jalma Hunsinger] and his companies.” ALO was a Benefactor B company and New Church Ventures was “a company associated with Southern Baptist causes.”\(^{286}\)

**Related Party Pseudonyms**

- Director A = Dwain Hoover;
- Benefactor A = Harold Friend;
- Benefactor B = Jalma Hunsinger;
- ALO = a Benefactor B company; and


\(^{286}\) Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 21.
• New Church Ventures = a company associated with Southern Baptist causes.

BFA disclosed in Footnote 13 of its 1995 financial statements, entitled “Related Parties,” that “a substantial portion of BFA’s transactions involve individuals or companies associated with Southern Baptist causes.” In Footnote 13, it described “some of the more significant transactions involving related parties,” including notes receivable from “Director A, Benefactor A, and Benefactor B or their companies” totaling $8,825,063, $2,400,000, and $53,797,827 (notes owed from ALO). Footnote 13 did not include an additional $37,400,000 in notes receivable owed to BFA from New Church Ventures, which was discussed in Footnote 3 entitled “Notes Receivable.”

The footnotes to the 1995 financial statements did not disclose the material nature of the total notes receivable owed to BFA from related parties ALO and New Church Ventures that accounted for 63 percent of BFA’s total notes receivable—or 30 percent of BFA’s total assets and more than ten times as much as BFA’s total net assets. This substantial concentration of credit given to ALO and New Church Ventures was also not disclosed in Footnote 2 in a subsection entitled: “Concentration of Credit Risk,” which stated: “Concentration of credit risk with respect to notes receivable are limited due to the fact that BFA requires notes receivable to be adequately collateralized.”


In connection with its 1996 audit of BFA, Arthur Andersen commented in a “Memorandum on Internal Control Structure” on BFA’s lack of review, analysis, and proper documentation of related party transactions.

Andersen also criticized the fact that the collateral on related party notes receivable was not adequately monitored. It noted that “certain of the notes receivable from individuals and companies affiliated with Southern

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290 Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 40–41.
Baptist causes had outstanding balances in excess of the current value of the underlying collateral.” Yet, Arthur Andersen did not require BFA to take a reserve or write-down on its notes receivable. Rather, in BFA’s 1996 financial statements, a footnote merely stated that “certain of the notes have outstanding balances that may be in excess of underlying collateral.”

Again, for year-end 1997, Arthur Andersen assessed BFA’s internal controls and criticized BFA for lack of review, analysis, and proper documentation of related party transactions and for failing to adequately monitor collateral on related party notes receivable. The criticisms stated in the 1997 Internal Control Memorandum were practically identical to those voiced by Andersen in 1996. In fact, in the 1997 memorandum, Arthur Andersen noted that its 1996 audit recommendations regarding related parties had not been fully implemented and encouraged management to do so.

The 1997 memorandum repeated, almost verbatim, Arthur Andersen’s observation “that certain of the notes receivable from individuals and companies affiliated with Southern Baptist causes had outstanding balances, which appeared to be in excess of the current value of the underlying collateral.”

Like its opinion in 1996, Arthur Andersen issued an unqualified opinion on BFA’s 1997 financial statements, without requiring adequate disclosures regarding the concentration of credit risk with related parties and the nature of the relationships with ALO and New Church Ventures. The footnote disclosures regarding the amounts due from related parties also appeared to be inadequate and misleading to financial statement users.

**Case Questions**

1. Since there is inherently greater risk that related party transactions occur on a basis other than “arm’s length,” what steps must a company take to properly disclose its related parties?

2. Please define what is meant by “arm’s length” basis. Next, explain why gains recorded on transactions with related parties would have greater inherent risk of being overstated.

3. Please consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Define what is meant by control environment. Next, comment about the impact that BFA’s related party disclosure practices would have on an auditor’s assessment of BFA’s control environment.

4. Consult Paragraph #60 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. What is the most relevant financial statement assertion(s) about the related party transaction activity at BFA? Why?

5. Please consult Paragraph #84 of PCAOB Auditing Standard No. 2. The paragraph states that “the auditor should
clearly link individual controls with the significant accounts and assertions to which they relate.” For the assertion identified in Question #4, identify a specific internal control activity that would help to prevent or detect a misstatement or lack of proper disclosure for BFA.
Case 4.11

Qwest: A Focus on Presentation and Disclosure

Synopsis

When Joseph Nacchio became Qwest’s CEO in January 1997, its existing strategy to construct a fiber-optic network across major cities in the United States began to shift toward communications services as well. By the time it released earnings in 1998, Nacchio proclaimed Qwest’s successful transition from a network construction company to a communications services provider. “We successfully transitioned Qwest … into a leading Internet protocol-based multimedia company focused on the convergence of data, video, and voice services.”

During 1999 and 2000, Qwest consistently met its aggressive revenue targets and became a darling to its investors. Yet, it was later uncovered that Qwest had fraudulently recognized $3.8 billion in revenues and fraudulently excluded $231 million in expenses. When the company announced its intention to restate revenues, its stock price plunged to a low of $1.11 per share in August 2002, from a high of $55 per share in July 2000. During this period, its market capitalization declined by 98 percent, from a high of $91 billion to a low of $1.9 billion.

Background

As part of its scheme to mislead the marketplace, Qwest executives often made false and misleading disclosures concerning revenues from its directory services unit, Qwest Dex Inc. (Dex). For example, Qwest manipulated revenue from Dex for 2000 and 2001 by secretly altering directory publication dates and the lives of directories.

Dex’s Changes to Publication Dates and Lives of Directories

Dex published telephone directories year-round in approximately 300 markets in 14 states. It earned revenue by

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291 Much of the information in this case is based on SEC v. Qwest, 40–42.


293 SEC v. Qwest, 1–2.
selling advertising space in its directories. Each of its directories typically had a life of 12 months, and Qwest traditionally recognized directory revenue over the life of the directory. However, in late 1999, Dex adopted a “point of publication” method of accounting and began to recognize all advertising revenue for a directory as soon as Dex began deliveries of that directory to the public.

In August 2000, Dex executives informed Qwest senior management that Dex would be unable to achieve the aggressive 2000 earnings’ targets that management had set for it. As one option for making up for the shortfall, Dex suggested that it could publish Dex’s Colorado Springs directory in December 2000 rather than January 2001 as scheduled, thereby allowing Qwest to recognize revenue from the directory in 2000 rather than 2001. One Dex executive expressed opposition, citing his concern that such a schedule change would merely reduce 2001 revenue and earnings. He also expressed his view that Qwest probably would be required to disclose the change in the regulatory filings with the SEC. Despite this executive’s opposition, Qwest senior management instructed Dex to move forward with the proposed change.

By recognizing revenue from the Colorado Springs directory in 2000, Qwest generated $28 million in additional revenue and $18 million in additional earnings before interest and tax, depreciation, and amortization (EBITDA) for the year. The additional revenue generated in 2000 accounted for about 30 percent of Dex’s 2000 year-over-year revenue increase. It further allowed Dex to show 6.6 percent year-over-year revenue growth versus 4.6 percent if the schedule change had not been made.

In Qwest’s 2000 Form 10-K, Qwest informed investors that Dex’s revenue for 2000 increased by almost $100 million. It wrote that the increase was due in part to “an increase in the number of directories published.” At the same time, it failed to inform investors that Dex generated nearly one-third of that amount by publishing the Colorado Springs directory twice in 2000. It also did not inform investors that the schedule change would produce a corresponding decline in Dex revenue for the first quarter of 2001.

For 2001, Qwest senior management established revenue and EBITDA targets for Dex that were higher than what Dex management believed was possible to achieve. In fact, the EBITDA target was $80–100 million greater than the amount Dex management believed was achievable. Dex management complained to Qwest’s senior management about the unrealistic targets. Yet, Qwest’s senior management not only refused to change the targets, but it also did not allow Dex a reduction in the targets to compensate for the revenue from the Colorado Springs directory that was recognized in 2000.
In March 2001, Dex management met with some of Qwest’s senior management to discuss “gap-closing” ideas for the first two quarters of 2001 in an attempt to achieve its 2001 financial targets. One idea was to advance the publication dates of several directories, thus, allowing Dex to recognize revenue in earlier quarters; another idea was to lengthen the lives of other directories from 12 to 13 months, thereby allowing Dex to bill each advertiser for one additional month of advertising fees in 2001. Senior managers at Qwest instructed the Dex managers to implement the changes. Similar changes were approved by senior management at Qwest and implemented by Dex to allow it to meet its third and fourth quarter financial targets.

During 2001, Dex advanced the publication dates or extended the lives of 34 directories. Those schedule changes produced $42 million in additional revenue and $41 million in additional EBITDA. Qwest’s Forms 10-Q for the first three quarters of 2001 stated that period-over-period improvements in Dex’s revenue were due in part to changes in the “mix” and/or the “lengths” of directories published. Like the 2000 Form 10-K, these reports did not include any information about the directory schedule changes or the reasons for those changes.

**Case Questions**

1. Describe why the revenue recognition practices of Dex were not appropriate under GAAP. Please be specific.

2. Please consider Paragraph #63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Identify one relevant financial statement assertion related to revenue recognized at Dex. Why is this assertion relevant?

3. Consult Paragraph #84 of PCAOB Auditing Standard No. 2. For the assertion identified in Question #2, identify a specific internal control activity that would help to prevent or detect a misstatement related to revenue recognition at Dex.

4. Consider the impact of the pressure exerted by Qwest’s senior management team to meet aggressive revenue and earnings targets. Please comment about why such a “tone at the top” would always have a pervasive effect on the reliability of financial reporting at an audit client like Qwest.

5. Please consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Next, comment about the impact that Qwest’s revenue disclosure practices would have on an auditor’s assessment of Qwest’ control environment.
Case 4.12

The Fund of Funds: A Focus on Evidence—Asset Valuation

Synopsis

As total assets reached $617 million in 1967, The Fund of Funds (FOF) was the most successful of the mutual funds offered by the Investor Overseas Services, Limited. In the late 1960s, FOF diversified into natural-resource asset investments. To do so, it formed a relationship with John King, a Denver oil, gas, and mineral investor and developer, whereby FOF would purchase oil and gas properties directly from his company, King Resources. By the 1970s, FOF was forced into bankruptcy.

It was later uncovered that King Resources had dramatically overcharged FOF for the properties that it sold to FOF. FOF’s bankruptcy trustee sued Arthur Andersen for failing to inform FOF that they were being defrauded by King Resources. Arthur Andersen was ultimately found liable and forced to pay around $70 million in civil damages, while John King was charged and convicted for masterminding the fraud against FOF.

Background

FOF incorporated FOF Proprietary Funds, Ltd. (FOF Prop) as an umbrella for its specialized investment accounts that were managed by outside investment advisors. Each investment advisor had a duty to act in FOF’s best interests and to avoid conflict of interests. Each advisor was compensated based on the realized and unrealized (paper) appreciation of their investment portfolios.294

In a presentation at a meeting of the FOF Board of Directors in Acapulco, Mexico, on April 5, 1968, John King suggested that FOF establish a proprietary account with an initial allocation of $10 million that would be invested in

a minimum of 40 properties. King described the role of King Resources as follows: “that of a vendor of properties to
the proprietary account, with such properties to be sold on an arms-length basis at prices no less favorable to the
proprietary account than the prices charged by King to its 200-odd industrial and other purchasers.” The Board
approved the idea, and the National Resources Fund Account was established.

Although no formal written agreement established the King Resources Corporation (KRC) as the investment
advisor for the NRFA, FOF’s clear intent was to use KRC’s expertise to locate and purchase speculative natural
resource investments. FOF had no means of valuing the assets proposed for investment by NRFA and did not possess
the industry expertise to do so.

**Independent Audit Relationships**

KRC, NRFA, and FOF were all audited by the same independent auditor, Arthur Andersen. Andersen’s Denver
office performed the KRC audits, as well as performed substantial work on the NRFA. The partner-in-charge and the
manager of the KRC audit held the same respective positions on the NRFA audit. Many aspects of the NRFA audit
were completed by using the records of KRC and, sometimes, Andersen staffers would even work on both the KRC
and NRFA audits contemporaneously. Finally, Arthur Andersen also audited various third parties that KRC sold
assets to in order to ultimately determine the valuations of those assets.

**FOF’s Natural Interest Purchases**

Beginning immediately after the Board of Directors’ meeting where NRFA was established, on April 5, 1968, it
began to purchase oil, gas, and mineral interests from KRC. King reported to the FOF Board of Directors on August
2, 1968, that $3 million of the initial authorization of $10 million was committed. For the year-end 1968 audit of
FOF by Andersen, the Denver office prepared a series of comparisons of prices charged by the King group to FOF,
other King affiliates, and other knowledgeable industry purchasers. The “Summary of 1968 Sales” shows the

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295 The Fund Of Funds, Limited, F.O.F. Proprietary Funds, Ltd., And IOS Growth Fund, Limited, A/K/A
Transglobal Growth Fund, Limited, Plaintiffs. v. Arthur Andersen & Co., Arthur Andersen & Co. (Switzerland), And
Arthur Andersen & Co., S.A., Defendants, No. 75 Civ. 540 (CES), United States District Court For The Southern
following with respect to sales to the King affiliates:

<table>
<thead>
<tr>
<th></th>
<th>Current Sales</th>
<th>Current Cost [to KRC]</th>
<th>Current Profit</th>
<th>Profit as a % of Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales to IAMC</td>
<td>$9,876,271</td>
<td>$8,220,324</td>
<td>$1,655,947</td>
<td>16.8%</td>
</tr>
<tr>
<td>Sales to Royal</td>
<td>6,566,491</td>
<td>4,085,544</td>
<td>2,480,947</td>
<td>37.8%</td>
</tr>
<tr>
<td>Sales to IOS</td>
<td>11,325,386</td>
<td>4,307,583</td>
<td>7,017,803</td>
<td>62.0%</td>
</tr>
</tbody>
</table>

In the same document, Andersen also computed the comparative profits for KRC, excluding interests sold to Royal and to IOS (which was essentially FOF). After subtracting those sales with higher markups, KRC’s profits as percentages of sales on its sales to its affiliates, Royal and IAMC, were substantially smaller than the profits on its sales to FOF.

In fact, KRC’s “Consolidated Sales to Industry,” dated September 30, 1969, illustrated that KRC’s profits on sales to FOF were 68.2 percent, as compared with average profits on all sales of nearly 36 percent. In comparing only the seven industry customers that purchased over $1 million of interests from KRC, FOF had the highest profit/sales ratio, at 68.2 percent. After FOF, the next highest profit/sales ratio, earned by KRC on sales to such customers was 24.4 percent; the lowest profit/sales ratio was 5 percent.

**Andersen’s Knowledge of the Purchases**

By Andersen’s account, “the earliest date when anyone employed by Andersen would have become aware of KRC’s 1968 sales to FOF was in early 1969.” At the same time, evidence exists that some FOF-KRC transactions were reviewed for the 1968 year-end audit in Andersen’s Denver office before January 28, 1969. Andersen auditors from its Denver office also testified that they did some “information gathering” on the NRFA for the FOF Prop audit as of December 31, 1968. They also testified that they obtained documents related to the FOF audit from KRC. Andersen’s auditors contend that their duty of confidentiality to KRC would prohibit it from having disclosed to FOF

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any relevant knowledge it may have had related to KRC’s costs.

Case Questions

1. Based on your understanding of audit evidence, did Arthur Andersen rely on competent and sufficient audit evidence in auditing the valuation assertion related to FOF’s natural resources assets? Why or why not?

2. Consider the series of comparisons prepared by the Denver office of Arthur Andersen of prices charged by the King group to FOF, King affiliates, and other knowledgeable industry purchasers. Can you think of any additional evidence that would have strengthened the “Summary of 1968 Sales”?

3. Please explain the primary purpose of substantive analytical procedures (i.e., the type of procedures that are completed during the testing stages of an audit). If you completed such procedures on FOF, do you think you could use KRC’s “Consolidated Sales to Industry,” which illustrated that KRC’s profits on sales to FOF were 68.2 percent, as compared to 36 percent on all other sales, to help execute the procedures? How?

4. Do you believe Andersen’s contention that they had a duty of client confidentiality to KRC that would, indeed, prohibit the firm from disclosing to FOF any relevant knowledge it may have had related to KRC’s costs? Why or why not?
Case 4.13

The Baptist Foundation of Arizona: A Focus on Evidence—Significant Transactions

Synopsis

The Baptist Foundation of Arizona (BFA), was organized as an Arizona non-profit organization primarily to help provide financial support for various Southern Baptist causes. Under William Crotts’s leadership, the foundation engaged in a major strategic shift in its operations. BFA began to invest heavily in the Arizona real estate market, and also accelerated its efforts to sell investment agreements and mortgage-backed securities to church members.

Two of BFA’s most significant affiliates were ALO and New Church Ventures. It was later revealed that BFA had set up these affiliates to facilitate the “sale” of its real estate investments at prices significantly above fair market value. In so doing, BFA’s management perpetrated a fraudulent scheme that cost at least 13,000 investors more than $590 million. In fact, Arizona Attorney General Janet Napolitano called the BFA collapse the largest bankruptcy of a religious nonprofit in the history of the United States.297

Background

A former BFA director incorporated both ALO and New Church Ventures. The entities had no employees of their own, and both organizations paid BFA substantial management fees to provide accounting, marketing, and administrative services. As a result, both ALO and New Church Ventures owed BFA significant amounts by the end of 1995. On an overall basis, BFA, New Church Ventures, and ALO had a combined negative net worth of $83.2 million at year-end 1995, $102.3 million at year-end 1996, and $124.0 million at year-end 1997.298

From 1984 to 1997, BFA’s independent auditor, Arthur Andersen, issued unqualified audit opinions on BFA’s combined financial statements. However, it was later revealed that BFA had sold real estate to ALO and New Church


Ventures and other related entities at its cost (or at a profit), even though the fair market value of the assets was significantly lower than the amounts recorded on BFA’s books.

**Year-End Transactions**

In December of each year, BFA engaged in significant year-end transactions with its related parties, ALO and New Church Ventures. These related party transactions primarily included real estate sales, gifts, pledges, and charitable contributions. Without these year-end transactions, BFA, on a stand-alone basis, would have been forced to report a significant decrease in net assets in each year, from 1991 to 1994. Yet, BFA did not disclose any information about these material related party transactions in its financial statements for the years 1991 to 1994.299

As an example, the significant real estate transactions that occurred in December 1995 with Harold Friend, Dwain Hoover, and subsidiaries of ALO enabled BFA to report an increase in net assets of $1.6 million for the year ended December 31, 1995, as opposed to a decrease in net assets that would have been reported. Importantly, for BFA to recognize a gain on these transactions in accordance with GAAP, the down payment for the buyer’s initial investment could not be “funds that have been or will be loaned, refunded, or directly or indirectly provided to the buyer by the seller, or loans guaranteed or collateralized by the seller for the buyer.”300 However, in reality, the cash for the initial down payment on many of these real estate sales can be traced back to BFA via transactions with affiliates of ALO and New Church Ventures.

**Foundation Investments, Inc.’s Sale of Santa Fe Trails Ranch II, Inc. Stock**

Santa Fe Trails Ranch II, Inc. was a subsidiary of Select Trading Group, Inc., which was a subsidiary of ALO. The only significant asset owned by Santa Fe Trails Ranch II was 1,357 acres of undeveloped land in San Miguel County, New Mexico.

On December 26, 1995, 100 percent of the issued and outstanding common stock of Santa Fe Trails Ranch II was transferred from Select Trading Group to ALO. ALO then sold the stock to New Church Ventures in exchange for a $1.6 million reduction in ALO’s credit line that was already owed to New Church Ventures. On the same day, New Church Ventures sold the Santa Fe Trails Ranch II stock to Foundation Investments, Inc., a BFA subsidiary, in

300 Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 25.
exchange for a $1.6 million reduction in the New Church Ventures’s credit line that was already owed to Foundation Investments. Also on the same day, Foundation Investments sold the Santa Fe Trails Ranch II stock to Harold Friend for $3.2 million, resulting in Foundation Investments recognizing a gain of $1.6 million in its financial statements.

The terms of the sale of the Santa Fe Trails Ranch II stock by Foundation Investments to Mr. Friend for $3.2 million was a 25 percent cash down payment ($800,000) with the balance of $2.4 million in a carry-back note receivable to Foundation Investments. To audit the transaction, Arthur Andersen’s senior auditor John Bauerle vouched the payment received from Friend via wire transfer back to the December 31, 1995 bank statement. However, he did not complete any additional work to determine the source of the cash down payment.

To assess the true nature and purpose of this series of transactions, Arthur Andersen reviewed a feasibility study and 1993 cash flow analysis for the proposed development of Cedar Hills. An independent appraisal was not obtained. Arthur Andersen prepared a net present value calculation using the 1993 cash flow analysis to support the $3.2 million value that Friend paid to Foundation Investments on December 26, 1995. Arthur Andersen accepted the $3.2 million value without questioning why that same property was valued at only $1.6 million when New Church Ventures sold it to Foundation Investments on the same day.

**TFCI’s Sale to Hoover**

In December 1995, The Foundation Companies, Inc., a for-profit BFA subsidiary, sold certain joint venture interests in real estate developments to Dwain Hoover and recognized a gain on the transaction of approximately $4.4 million. In this particular transaction, the cash down payment from Hoover to The Foundation Companies of approximately $2.9 million was funded by a loan to Hoover from FMC Holdings, Inc., a subsidiary of ALO. Importantly, FMC received its own funding from BFA and New Church Ventures.

The details of this transaction were documented in Arthur Andersen’s workpapers, primarily through a memorandum prepared by Arthur Andersen senior auditor John Bauerle on April 13, 1996. According to his memo, Bauerle concluded that the transaction did meet the criteria for gain recognition pursuant to SFAS No. 66. However, Bauerle’s memorandum did not include any documentation to support how Arthur Andersen tested the source of the

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cash down payment to help assure that the down payment was not directly or indirectly provided by BFA.

In early 1996, Arthur Andersen was auditing The Foundation Companies and prepared their annual management representation letter to be signed by the Foundation Company’s Chief Financial Officer, Ron Estes. However, because of the previously described Hoover transaction, Estes refused to sign the management representation letter. CFO Estes protested against the Hoover transaction and ultimately resigned in June 1996. Arthur Andersen’s audit workpapers related to the Foundation Companies 1995 audit did not address the absence of Estes’s signature on the final management representation letter or indicate if it made any inquiries of Estes as to why he refused to sign the letter.

**Case Questions**

1. Please consider the sale of the Santa Fe Trails Ranch II stock by Foundation Investments to Friend. Do you believe that the auditor should have completed any additional testing beyond vouching the payment received from Friend? Provide the rationale for your decision.

2. Assuming that you would complete additional testing on the transaction described in Question 1, what is the most relevant financial statement assertion related to the transaction? Which audit procedures would you recommend to test the assertion? Why?

3. Please consult the key provisions of SFAS #66. Why did The Foundation Company’s sale of the joint venture interests in real estate developments to Dwain Hoover fail to meet the provisions of SFAS #66? In your answer, make certain to note the impact of related party activity on your conclusion.

4. If you were the lead engagement partner at BFA, how would you have responded to the refusal of CFO Estes to sign the management representation letter? Why?
Appendix

Company Cases

The case readings have been developed solely as a basis for class discussion. The case readings are not intended to serve as a source of primary data or as an illustration of effective or ineffective auditing.

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Case A.1

Enron

Synopsis

In its 2000 Annual Report, Enron prided itself on having “metamorphosed from an asset-based pipeline and power generating company to a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people.” Enron’s strategy seemed to pay off; in 2000, it was the seventh largest company on the Fortune 500, with assets of $65 billion and sales revenues of $100 billion. From 1996 to 2000, Enron’s revenues had increased by more than 750 percent and 65 percent per year, which was unprecedented in any industry. Yet, just a year later, Enron filed for bankruptcy, and billions of shareholder dollars and retirement savings were lost.

Enron’s auditor during this period was Arthur Andersen, LLP. Andersen was one of the five largest international accounting firms.

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public accounting firms and was convicted of obstruction of justice in connection with shredding documents related to the Enron audit. And although this conviction was overturned in 2005 by the United States Supreme Court, Andersen’s decision to destroy evidence cast suspicion on whether Andersen was trying to cover up any guilt related to a failure to perform its professional responsibilities.

Enron’s First Few Years

In 1985, Enron had assets along the three major stages of the supply chain of natural gas: production, transmission, and distribution. Natural gas was “produced” from deposits found underground. The natural gas was transmitted via pipelines, or networks, of underground pipes, either directly to industrial customers or sold to regional gas utilities, which then distributed the gas to smaller businesses and customers. Some companies in the industry had assets related to specific activities within the supply chain. For example, some companies owned pipelines, but did not produce their own gas. These companies often entered into long-term “take or pay” contracts, whereby they paid for minimum volumes in the future at prearranged prices, to protect against supply shortages.

In early 1986, Enron reported a loss of $14 million for its first year. As a result, the company employed a series of cost-cutting measures, including layoffs and pay freezes for top executives. Enron also started selling off assets to reduce its debt. Nevertheless, Enron’s financial situation was still bleak in 1987. That year, Moody’s downgraded its credit rating to “junk bond” status.305

Impact of Significant Industry Change on Enron

Enron faced significant change in its industry environment due to the government’s decision in the mid-1980s to deregulate the once-highly regulated industry. The government, which had dictated the prices pipeline companies paid for gas and the prices they could charge their customers, decided to allow the market forces of supply and demand to dictate prices and volumes sold. As part of this process, the government required that pipeline companies provide “open access” to their pipelines to other companies wanting to transport natural gas, so that pipeline

companies would not have an unfair competitive advantage.\textsuperscript{306}

\textbf{Enron’s Natural Gas Pipeline Business}

Enron adapted by providing “open access” to its pipelines, i.e., charging other firms for the right to use them. It also took advantage of the ability to gain “open access” to pipelines owned by other companies. For example, in 1988, Enron signed a 15-year contract with Brooklyn Union to supply gas to a plant being built in New York. Because Brooklyn Union was not connected to Enron’s pipeline system, Enron needed to contract with another pipeline company to transport the gas to Brooklyn Union. Enron was, therefore, assuming added risks related to the transportation of the gas. The long-term nature of the contract was also risky because prices could rise to a level that would make the contract unprofitable.\textsuperscript{307}

\textbf{Enron Expands into Natural Gas Trading and Financing}

Enron capitalized on the introduction of market forces into the industry by becoming involved in natural gas trading and financing. Enron served as an intermediary among producers who contracted to sell their gas to Enron and gas customers who contracted to purchase gas from Enron. Enron collected as profits the difference between the prices at which it sold the gas less the prices at which it purchased the gas. Enron’s physical market presence (i.e., owning the pipelines and charging a price for distribution that was proportional to the spot price of gas it might purchase) helped mitigate the risk of a price increase of the gas it was purchasing.\textsuperscript{308}

In response to the problem of getting producers to sign long-term contracts to supply gas, Enron started giving such producers cash up-front instead of the payment over the life of the contract. Enron then allowed for the natural gas contracts it devised—which were quite complex and variable, depending on different pricing, capacity, and transportation parameters—to be traded.


\textsuperscript{307} Bethany McLean and Peter Elkind, \textit{The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron} (New York: Penguin Group, 2003), p. 34.

Enron Expands beyond Natural Gas

Enron decided to apply its gas-trading model to other markets, branching out into electricity and other commodity markets, such as paper and chemicals. To accomplish its expansion strategy, Enron sought to pursue an “asset light” strategy. Enron’s goal was to achieve the advantages of a presence in the physical market, without the disadvantages of huge fixed capital expenditures. For example, in natural gas, Enron divested its assets related to pumping gas at the wellhead or to selling gas to customers, and then set out to acquire assets related to midstream activities, such as transportation, storage, and distribution. By late 2000, Enron owned 5,000 fewer miles of natural gas pipeline than when founded in 1985; in fact, its gas transactions represented 20 times its existing pipeline capacity.

In addition, Enron undertook international projects involving the construction and management of energy facilities outside the United States—in the United Kingdom, Eastern Europe, Africa, the Middle East, India, China, and Central and South America. Established in 1993, the Enron International Division did not adhere to the asset-light strategy pursued by other divisions. Enron also expanded aggressively into broadband, the use of fiber optics to transmit audio and video. Among its goals in that business were to deploy the largest open global broadband network in the world.

Enron’s Changes to Accounting Procedures

As a result of its change in business strategy, Enron made significant changes to several of its accounting procedures. For example, Enron began establishing several “special purpose entities” in many aspects of its business. A special purpose entity (SPE) is an entity—partnership, corporation, trust, or joint venture—created for a limited purpose, with limited activities and a limited life. A company forms an SPE, so outside investors are assured that they will only be exposed to the risk of the SPE and its particular purpose, such as building a gas pipeline, and not the risks


associated with the entire company. In addition, the SPE also protects the investment of outside investors by giving them control over its activities. If an SPE satisfies certain conditions, it does not have to be consolidated with the sponsoring company.

**Conditions for Nonconsolidation of SPEs**

A company is not required to consolidate the asset and liabilities of the SPE into those contained on its own balance sheet, and it may record gains and losses on transactions with the SPE, if two conditions are met:

1. An owner independent of the company must own a “substantive” equity interest (of at least 3 percent of the SPE’s assets, and that 3 percent must remain at risk throughout the transaction), and

2. The independent owner must exercise control of the SPE.

The 3 percent minimum equity owned by outside investors was created in 1990 by EITF 90–15 and formalized by FASB Statement No.’s 125 and 140. This standard represented a major departure from typical consolidation rules, which generally required an entity to be consolidated if a company owned (directly or indirectly) 50 percent or more of the entity.\(^{312}\) Consolidation rules for SPEs were also controversial because a company could potentially use an SPE for fraudulent purposes, such as “hiding” debt or nonperforming assets by keeping these items off its own consolidated balance sheet.

**JEDI and Chewco**

In 1993 Enron and the California Public Employees Retirement System (CalPERS) formed an SPE, a $500 million 50–50 partnership they called Joint Energy Development Investments Limited (JEDI).\(^{313}\) Enron was not required to consolidate the partnership within Enron’s financial statements because it did not own more than 50 percent of the venture.

In 1997, Enron offered to buy out CalPERS’ interest in JEDI. To maintain JEDI as an unconsolidated entity,


\(^{313}\) JEDI was also a sly nod to the Star Wars films; CFO Andy Fastow, who devised the partnership, was a Star Wars fan.
Enron needed to identify a new limited partner. Enron’s CFO Andrew Fastow proposed that Enron form another SPE, named Chewco Investments (after *Star Wars* character Chewbacca), the bulk of whose equity investment would come from third-party investors, to buy out CalPERS’s JEDI interest.\footnote{William C. Powers, Jr., Raymond S. Troubh, Herbert S. Winokur, Jr., *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.*, February 1, 2002, p. 43.}

**Chewco’s Capital Structure**

Unsuccessful in obtaining outside equity, Enron created a capital structure for Chewco that had three elements:

1. $250 million unsecured subordinated loan to Chewco from Barclays Bank (Enron would guarantee the loan);
2. $132 million advance from JEDI to Chewco under a revolving credit agreement; and
3. $11.5 million in equity (representing approximately 3 percent of total capital) from Chewco’s general and limited partners.\footnote{William C. Powers, Jr., Raymond S. Troubh, Herbert S. Winokur, Jr., *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.*, February 1, 2002, p. 49.}

**Chewco’s Partners**

Michael Kopper, an Enron employee who reported to CFO Fastow, was the general partner of Chewco. The limited partner of Chewco was an entity called Big River Funding LLC, whose sole member was an entity called Little River Funding LLC. Kopper had invested $115,000 in Big River and $10,000 in Little River but transferred these investments to William Dodson (who allegedly may have been Kopper’s domestic partner). As such, Kopper technically had no ownership interest in Chewco’s limited partner. The remaining $11.4 million was provided by Barclays Bank in the form of “equity loans” to Big River and Little River.

Barclays required Big River and Little River to establish cash reserve accounts of $6.6 million and that the reserve accounts be fully pledged to secure repayment of the $11.4 million. JEDI, of which Enron still owned 50 percent, made a special $16.6 million distribution to Chewco, out of which $6.6 million could be used to fund the cash reserve accounts.\footnote{William C. Powers, Jr., Raymond S. Troubh, Herbert S. Winokur, Jr., *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.*, February 1, 2002, pp. 48–51.} Please refer to Figure 4.1.1 in Section 4, on page 114, for a visual depiction of the Chewco
Andersen’s Audit of the Chewco Transaction

Enron’s auditor Arthur Andersen requested that Enron provide all the documentation in its possession relating to the Chewco transaction. In its audit of the transaction, Andersen reviewed the following:\footnote{317 Thomas H. Bauer, Prepared Witness Testimony at Subcommittee on Oversight and Investigations related to “Financial Collapse of Enron Corp,” February 7, 2002.}

- The minutes of Enron’s Executive Committee of the Board of Directors approving the transaction
- The $132 million loan agreement between JEDI and Chewco
- Enron’s guarantee agreement of a $240 million from Barclays to Chewco
- An amended JEDI partnership agreement
- A representation letter from Enron and a representation letter from JEDI, each of which stated that related party transactions had been disclosed and that all financial records and related data had been made available to Andersen.

Andersen received confirmation regarding the loan agreement from a Chewco representative. Andersen also requested that Enron provide documents relating to Chewco’s formation and structure. However, Enron told Andersen that it did not have these documents and could not obtain them because Chewco was a third party with its own legal counsel and ownership independent of Enron.\footnote{318 Thomas H. Bauer, Prepared Witness Testimony at Subcommittee on Oversight and Investigations related to “Financial Collapse of Enron Corp,” February 7, 2002.} Andersen allegedly accepted this explanation and only relied on the evidence it had been given.

When the Chewco transaction was reviewed closely in late October and early November 2001, Enron and Andersen concluded that Chewco was an SPE without sufficient outside equity and that it should have been consolidated into Enron’s financial statements. The retroactive consolidation of Chewco and the investment partnership in which Chewco was a limited partner decreased Enron’s reported net income by $28 million (out of $105 million total) in 1997, by $133 million (out of $703 million total) in 1998, by $153 million (out of $893 million total) in 1999, and by $91 million (out of $979 million total) in 2000. It also increased Enron’s reported debt by

**Enron’s Use of Mark-to-Market Accounting**

Enron also lobbied the SEC about the use of mark-to-market (MTM) accounting for its trading business, which allowed for the present value (rather than the “actual value,” which was used in its original natural gas business) of the stream of future inflows and expenses under a contract to be recognized as revenues and expenses, respectively, once the contract was signed.

In 1992, the SEC’s chief accountant, Walter Scheutz, granted Enron permission to use MTM during the first quarter of its fiscal year ended December 31, 1992. However, he also said that MTM could be used only in Enron’s natural gas trading business.\footnote{Robert Bryce, \textit{Pipe Dreams: Greed, Ego, and the Death of Enron} (New York: Perseus Book Group, 2002), p. 67.} Enron’s chief financial officer, Jack Tompkin, wrote back to Scheutz informing him that “Enron has changed its method of accounting for its energy-related, price-risk management activities effective January 1, 1991 … the cumulative effect of initial adoption of mark-to-market accounting, as well as the impact on 1991 earnings is not material.”\footnote{Robert Bryce, \textit{Pipe Dreams: Greed, Ego, and the Death of Enron} (New York: Perseus Book Group, 2002), p. 67.}

Enron was the first company outside the financial services industry to use MTM accounting.\footnote{Bala G. Dharan and William R. Bufkins, “Red Flags in Enron’s Reporting of Revenues and Key Financial Measures,” March 2003, pre-publication draft (www.ruf.rice.edu/~bala/files/dharan-bufkins_enron_red_flags_041003.pdf), pp. 7–11.}

While the value of stock portfolios varied directly with changes in stock prices, the value of natural gas contracts were harder to assess. They often required complex valuation formulas with multiple assumptions for the formulas’ variables, such as interest rates, customers, costs, and prices. These assumptions have a major impact on value and are related to long time periods, in some cases, as long as 20 years.

**Early Application of MTM Accounting: Sithe Energies Agreement**

One of the earliest contracts for which Enron employed MTM accounting was an agreement for Enron to supply...
Sithe Energies with 195 million cubic feet of gas per day for 20 years for a plant that Sithe was planning to build in New York. The estimated value of the gas to be supplied was $3.5 to $4 billion. Using MTM, Enron was able to book profits from the contract even before the plant started operating.\textsuperscript{323}

Before MTM, it would have recognized the \textit{actual} costs of supplying the gas and \textit{actual} revenues received from selling the gas in each time period. Using MTM meant that as soon as a long-term contract was signed, the \textit{present value} of the stream of future inflows under the contract was recognized as revenues and the \textit{present value} of the expected costs of fulfilling the contract were expensed.\textsuperscript{324} Changes in value were recognized as additional income or losses (with corresponding changes to the relevant balance sheet accounts) in subsequent periods.\textsuperscript{325}

**Enron’s Expanded Use of MTM Accounting**

Although the SEC had initially given approval for Enron to use MTM in the accounting of natural gas futures contracts, Enron quietly began using MTM for electric power contracts and trades as well.\textsuperscript{326} In one example, Enron signed a 15-year $1.3 billion contract to supply electricity to Eli Lilly. Enron calculated the present value of the contract as more than half a billion dollars and recognized this amount as revenue. It also reported estimates for the costs associated with servicing the contract. At the time, Indiana had not yet deregulated electricity. Thus, Enron needed to predict when Indiana would deregulate, as well as the impact of the deregulation on the costs related to the


Enron also extended MTM accounting to other businesses. In another example, Enron signed a 20-year agreement with Blockbuster Video in July 2000 to introduce entertainment on-demand. Enron set up pilot projects in Portland, Seattle, and Salt Lake City to store the entertainment and distribute it over its broadband network. Based on these pilot projects, Enron recognized estimated profits of more than $110 million for the Blockbuster deal. Technical viability and market demand were difficult to predict in these initial stages. Canceled in March 2001, the Blockbuster deal never reached past the pilot stage, yet significant profits were recognized by Enron on the deal.

**Enron’s Relationship with Auditor Arthur Andersen**

Enron paid Arthur Andersen $46.8 million in fees for auditing, business consulting, and tax work for the fiscal year ended August 31, 1999; $58 million in 2000; and more than $50 million in 2001. Andersen was collecting a million dollars a week from Enron in the year before Enron’s cash. It was one of Andersen’s largest clients.

More than half of that amount was for fees that were charged for nonaudit services. In 2000, for example, Enron paid Andersen $25 million for audit services and $27 million for consulting and other services, such as internal audit services.

Andersen had performed Enron’s internal audit function since 1993. That year, Andersen had hired 40 Enron personnel, including the vice president of internal audit, to be part of Andersen’s team providing internal audit

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services.\textsuperscript{332} In 2000, as SEC chairman Arthur Levitt was trying to reform the industry practice of an audit firm also offering consulting services to their audit clients, Enron’s Chairman and CEO Ken Lay sent a letter to Levitt (the letter was secretly coauthored by Andersen partner David Duncan), in which he wrote:

> While the agreement Enron has with its independent auditors displaces a significant portion of the activities previously performed by internal resources, it is structured to ensure that Enron management maintains appropriate audit plan design, results assessment, and overall monitoring and oversight responsibilities … Enron has found its “integrated audit” arrangement to be more efficient and cost-effective than the more traditional roles of separate internal and external auditing functions.\textsuperscript{333}

At Andersen, an audit partner’s individual compensation depended on his or her ability to sell other services (in addition to auditing) to clients.\textsuperscript{334} Therefore, the nonaudit services provided to Enron had a big impact on the salary of the lead Andersen partner on the Enron engagement, David Duncan, who was earning around $1 million a year.\textsuperscript{335}

After graduating from Texas A&M University, Duncan joined Andersen in 1981, made partner in 1995, and was named the lead partner for Enron two years later. Duncan developed a close personal relationship with Enron’s Chief Accounting Officer (CAO) Richard Causey, who himself had worked at Arthur Andersen for almost nine years. Duncan and Causey often went to lunch together, and their families had even taken vacations together.\textsuperscript{336}

Causey, who came to Enron in 1991, was appointed CAO in 1997. Causey was responsible for recruiting many


Andersen alumni to work at Enron. Over the years, Enron hired at least 86 Andersen accountants.\(^{337}\) Several were in senior executive positions, including Jeffrey McMahon, who had served as Enron’s treasurer and president, and Vice President Sherron Watkins.

Although Andersen had separate offices in downtown Houston, Duncan and up to one hundred Andersen managers had a whole floor available to them within Enron’s headquarters in Houston.\(^ {338}\) Duncan once remarked that he liked having the office space there because it “enhanced our ability to serve” and to “generate additional work.”\(^{339}\) Andersen boasted about the closeness of their relationship in a promotional video. “We basically do the same types of things…. We’re trying to kinda cross lines and trying to, you know, become more of just a business person here at Enron,” said one accountant. Another spoke about the advantage of being located in Enron’s building: “Being here full-time year-round day-to-day gives us a chance to chase the deals with them and participate in the deal making process….”\(^{340}\)

In fact, Andersen and Enron employees went on ski trips and took annual golf vacations together. They played fantasy football against each other on their office computers and took turns buying each other margaritas at a local Mexican restaurant chain. One former senior audit manager at Andersen said that it was “like these bright geeks at Andersen suddenly got invited to this really cool, macho frat party.”\(^ {341}\)

**PSG’s Disapproval of Special Purpose Entities and the Audit Team’s**


Response

In 1999, Enron’s CFO, Andrew Fastow, spoke to David Duncan about Enron’s plan to set up a special purpose entity (later called LJM), a financing vehicle used to access capital or increase leverage without adding debt to a firm’s balance sheet. After the discussion with Fastow, Duncan asked for the advice of the Professional Standards Group (PSG).

A member of the PSG, Benjamin Neuhausen, represented the group’s disapproval in an e-mail written to Mr. Duncan on May 28, 1999: “Setting aside the accounting, (the) idea of a venture equity managed by CFO is terrible from a business point of view…. Conflicts of interest galore. Why would any director in his or her right mind ever approve such a scheme?” he wrote.342

In addition, PSG was firmly against the idea of Enron’s recording gains on the sales of assets (or immediate gains on any transactions) to the Fastow-controlled special purpose entity. In response to the recording of gains, Duncan wrote in a June e-mail, “I’m not saying I’m in love with this either … But I’ll need all the ammo I can get to take that issue on … on your point 1, (i.e., the whole thing is a bad idea), I really couldn’t agree more.” Yet, Duncan later told Mr. Fastow that Andersen would sign off on the transaction, under a few conditions, one of which was that Mr. Fastow obtain the approval of Enron’s chief executive and its Board of Directors.343

Shortly after, Carl Bass, who was promoted to PSG in December 1999, raised concerns over the sale of some equity options within the LJM special purpose entity. Bass wrote to his boss John Stewart in an e-mail, “This is a big item and the team apparently does not want to go back to the client on this. I think at a minimum the Practice Director needs to be made aware of this history and our opposition to the accounting.”344 However, the memo


Duncan’s team prepared to document the deal indicated that Bass “concurred with our conclusions.”

Bass continued to object to the LJM transaction, writing in an e-mail to Stewart (Bass’s boss) in February 2000, “This whole deal looks like there is no substance. The only money at risk here is $1.8 million in a bankrupt-proof SPE. All of the money here appears to be provided by Enron…” Duncan’s team did not address Bass’ concerns and, in fact, continued to misrepresent his views to the client.

In late 2000, Duncan asked Bass for more advice on how best to account for four Enron SPEs known as Raptors. Enron wanted to lump together the financial results for all the entities, so that the more profitable ones could offset losses being garnered by others. Bass opposed the idea. Nevertheless, Duncan later decided that Andersen would “accept the client’s position,” with some modifications.

In February 2001, Andersen held a routine annual risk assessment meeting to determine whether to keep Enron as a client. Some partners raised concerns relating to how much debt Enron was not putting on its balance sheet, Fastow’s conflict of interest, and the lack of disclosure in the company’s financial footnotes. Duncan reassured his fellow partners.

Carl Bass was removed from the Enron account in March 2001. Bass wrote to Stewart (Bass’s boss) in an e-mail, “Apparently, part of the process issue stems from the client (Enron) knowing all that goes on within our walls on our discussions with respect to their issues… We should not be communicating with the client that so and so said this and I could not get this past so and so in the PSG… I have first hand experience on this because at a recent EITF meeting some lower level Enron employee who was with someone else from Enron introduced herself to me by saying she had heard my name a lot—‘so you are the one that will not let us do something….’ I have also noted a


trend on this engagement that the question is usually couched along the lines ‘will the PSG support this?’ When a call starts out that way, it is my experience that the partner is struggling with the question and what the client wants to do.” Stewart complained to a senior partner about Bass’s removal. Duncan called Mr. Stewart and explained that two Enron executives, Richard Causey and John Echols, had pushed for Bass’s removal.  

**Comprehensive List of Case Questions**

1. What is auditor independence and what is its significance to the audit profession? What is the difference between independence in appearance and independence in fact?

2. Please consult Paragraph 32 of PCAOB Auditing Standard No. 2. In what ways, if any, was Arthur Andersen’s independence in fact or in appearance potentially impacted on the Enron audit?

3. Refer to Section 201 of SOX. Please identify the services provided by Arthur Andersen that are no longer allowed to be performed. Do you believe that Section 201 was needed? Why or why not?

4. Please refer to Section 203 and Section 206 of SOX. How would these sections of the law have impacted the Enron audit? Do you believe that these sections were needed? Why or why not?

5. Please explain why an accounting and auditing research function (like Andersen’s PSG) is important in the operations of a CPA firm. What role does the function play in completing the audit?

6. Please consult Section 103 of SOX. Do you believe that the Engagement Leader of an Audit (like David Duncan on the Enron audit) should have the authority to overrule the opinions and recommendations of the accounting and auditing research function (like the PSG)? Why or why not? Do you think that a PCAOB inspector would approve of this practice?

7. After Carl Bass was removed from the Enron account, he indicated to his boss that he did not believe Enron should have known about internal discussions regarding accounting and auditing issues. Do you agree with Bass’s position? Why or why not?

8. Please consult Section 203 of SOX. Do you believe that this provision of the law goes far enough, that is, do you

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believe the audit firm itself (and not just the partner) should have to rotate off an audit engagement every five years? Why or why not?

9. Based on your understanding of inherent risk assessment, please identify three specific factors about Enron’s business model in the late 1990s that are likely to impact your audit procedures if you were conducting an audit of the financial statements at Enron.

10. Please consult Q39 and Q43 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of the inherent risks identified at Enron (in Question #1) would influence the nature, timing, and extent of your audit work at Enron.

11. Please consult Paragraphs #68–70 of the PCAOB Auditing Standard No. 2. Consider how the change in industry regulation and Enron’s resulting strategy shift would impact your inherent risk assessment for the relevant financial statement assertions about the revenue account. Specifically, please explain why your understanding of Enron’s strategy impacts such inherent risk assessment.

12. Consult Paragraph #24 of PCAOB Auditing Standard No. 2 and SAS No. 99. Please brainstorm about how a revenue recognition fraud might occur under Enron’s strategy in the late 1990s. Can you think of a control procedure that would prevent, detect, or deter such a fraud?

13. Please consult the key provisions of Emerging Issues Task Force (EITF) 90-15. How did Enron’s Chewco SPE fail to meet the outside equity requirement for nonconsolidation? Did Enron meet the “control” requirement for nonconsolidation?

14. Based on your understanding of the audit evidence, did Arthur Andersen rely on sufficient and competent audit evidence in its audit of the Chewco transaction? Why or why not?

15. Please consult Section 401 of SOX. How would Section 401 apply on the Enron audit? Do you think that Section 401 would have improved the presentation of Enron’s financial statements?

16. Consult Paragraph #60 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. What is the relevant financial statement assertion(s) about which of the financial statement account(s) related to the Chewco transaction? Please provide adequate support for your answer.

17. Please consider the Sithe Energies contract described in the case. Does the use of MTM accounting violate the revenue recognition principle of GAAP? Why or why not?

18. Please refer to Paragraph #72 of PCAOB Auditing Standard No. 2. As an auditor, would you consider the
natural gas trading revenue recognized using MTM accounting as having a “differing level” of inherent risk than other types of revenue recognized by Enron? Why or why not?

19. Refer to Paragraph #74 of PCAOB Auditing Standard No. 2. Can you identify one point in the natural gas revenue recognition process where a member of Enron’s management team might be able to perpetrate a fraudulent misstatement related to one of the relevant financial statement assertions? Please identify the assertion and use the case information to provide an example for your answer.

20. Please refer to Paragraphs #84–85 of PCAOB Auditing Standard No. 2. Identify one specific control activity that could be designed to prevent the misstatement (that you identified) from occurring. Next, identify one specific control procedure that could be designed to detect the misstatement (that you identified in Question #3) from occurring.
Case A.2

Waste Management

Synopsis

In February 1998, Waste Management announced that it was restating the financial statements it had issued for the years 1993 through 1996. In its restatement, Waste Management said that it had materially overstated its reported pretax earnings by $1.43 billion. After the announcement, the company’s stock dropped by more than 33 percent and shareholders lost over $6 billion.

The SEC brought charges against the company’s founder Dean Buntrock and five other former top officers. The charges alleged that management had made repeated changes to depreciation related estimates to reduce expenses and had employed several improper accounting practices related to capitalization policies, also designed to reduce expenses.\(^\text{350a}\)

The SEC also brought charges against Waste Management’s auditor Arthur Andersen, alleging that it knowingly or recklessly issued materially false and misleading audit reports for the period 1993 through 1996. Andersen settled with the SEC for $7 million, the largest-ever civil penalty at the time, without admitting or denying any allegations or findings.\(^\text{351}\)

History

In 1956, Dean Buntrock took over Ace Scavenger, a garbage collector owned by his then father-in-law who had recently died. After merging Ace with a number of other waste companies, Buntrock founded Waste Management in

\(^{350a}\) SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).

1968. Under Buntrock’s reign as its CEO, the company went public in 1971, and then expanded during the 1970s and 1980s though several acquisitions of local waste hauling companies and landfill operators. At one point, the company was performing close to 200 acquisitions a year.\footnote{Waste Management: Change with the Market or Die,” Fortune, January 13, 1992.}

From 1971 to 1991, the company enjoyed 36 percent average annual growth in revenue and 36 percent annual growth in net income. By 1991, Waste Management had become the largest waste removal business in the world, with revenue of more than $7.5 billion.\footnote{SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).} Despite a recession, Buntrock and other executives at Waste Management continued to set aggressive goals for growth. For example, in 1992, the company forecasted that revenue and net income would increase by 26.1 percent and 16.5 percent, respectively, over 1991’s figures.\footnote{SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).}

**Waste Management’s Core Operations**

Waste Management’s core solid waste management business in North America consisted of the following major processes: collection, transfer, and disposal.

**Collection**

Solid waste management collection to commercial and industrial customers was generally performed under one- to three-year service agreements. Most of its residential solid waste collection services were performed under contracts with—or franchises granted by—municipalities giving it exclusive rights to service all or a portion of the homes in

\footnote{SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).}

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\footnote{SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).}
their respective jurisdictions. These contracts or franchises usually ranged in duration from one to five years. Factors that contributed to the determination for fees collected from industrial and commercial customers were market conditions, collection frequency, type of equipment furnished, length of service agreement, type and volume or weight of the waste collected, distance to the disposal facility, and cost of disposal. Similar factors determined the fees collected in the residential market.\textsuperscript{358}

**Transfer**

As of 1995, Waste Management operated 151 solid waste transfer stations, facilities where solid waste was received from collection vehicles, and then transferred to trailers for transportation to disposal facilities. In most instances, several collection companies used the services of these facilities, which were provided to municipalities or counties. Market factors, the type and volume or weight of the waste transferred, the extent of processing of recyclable materials, the transport distance involved, and the cost of disposal were the major factors that contributed to the determination of fees collected.\textsuperscript{359}

**Disposal**

As of 1995, Waste Management operated 133 solid waste sanitary landfill facilities, 103 of which were owned by the company. All of the sanitary landfill facilities were subject to governmental regulation aimed at limiting the possibility of water pollution. In addition to governmental regulation, land scarcity, and local resident opposition also conspired to make it difficult to obtain permission to operate and expand landfill facilities in certain areas. The development of a new facility also required significant up-front capital investment and a lengthy amount of time, with the added risk that the necessary permit might not be ultimately issued. In 1993, 1994, and 1995 approximately 52 percent, 55 percent, and 57 percent, respectively, of the solid waste collected by Waste Management was disposed of in sanitary landfill facilities operated by it. These facilities were typically also used by other companies and government agencies on a noncontract basis for fees determined by market factors, and the type and volume or weight of the waste.\textsuperscript{360}

\textsuperscript{358} 1995 10-K.

\textsuperscript{359} 1995 10-K.

\textsuperscript{360} 1995 10-K.
Corporate Expansion

As the company grew, Waste Management expanded its international operations and into new industries, including hazardous waste management, waste-to-energy, and environmental engineering businesses. By the mid-1990s, Waste Management had five major business groups that provided the following services: solid waste management, hazardous waste management, engineering and industrial services, trash-to-energy, water treatment, and air quality services, and international waste management. (See Table 2.2.1 for a description of the primary services these groups provided and revenues in 1993, 1994, and 1995.)

Challenges

By the mid-1990s, the company’s core North American solid waste business was suffering from intense competition and excess landfill capacity in some of its markets. New environmental regulations also added to the cost of operating a landfill, and they made it more difficult and expensive for Waste Management to obtain permits for constructing new landfills or expand old ones.\textsuperscript{361}

\textbf{TABLE 2.2.1 Waste Management’s Major Business Groups}

<table>
<thead>
<tr>
<th>Business Group</th>
<th>Services</th>
<th>Revenues ($000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Solid waste management</td>
<td>Garbage collection, transfer, resource recovery, and disposal for commercial, industrial, municipal, and residential customers, as well as to other waste management companies. Included recycling of paper, glass, plastic and metal, removal of methane gas from sanitary landfill facilities for use in electricity generation, and medical and infectious waste management services to hospitals and other.</td>
<td>4,702,166</td>
</tr>
</tbody>
</table>

\textsuperscript{361} SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).
<table>
<thead>
<tr>
<th>Service</th>
<th>Description</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hazardous waste management</td>
<td>Chemical waste treatment, storage, disposal, and related services provided commercial and industrial customers, governmental entities, and other waste management companies by Waste Management and Chemical Waste Management (CWM), a wholly owned subsidiary; onsite integrated hazardous waste management services provided by Advanced Environmental Technical Services (AETS), a 60 percent-owned subsidiary; and low-level radioactive waste disposal services provided by subsidiary Chem-Nuclear Systems.</td>
<td>661,860</td>
</tr>
<tr>
<td>Engineering and industrial</td>
<td>Through Rust International, a 60 percent-owned subsidiary provides environmental and infrastructure engineering and consulting services, primarily to clients in government and in the chemical, petrochemical, nuclear, energy, utility, pulp and paper, manufacturing, environmental services, and other industries.</td>
<td>1,035,004</td>
</tr>
<tr>
<td>Trash-to-energy, water treatment, air quality</td>
<td>Through Wheelabrator Technologies Inc. (WTI), a 58 percent-owned subsidiary, develops, arranges financing for, operates, and owns facilities that dispose of trash and other waste materials by recycling them into electrical or steam energy. Also designs, fabricates, and installs technologically advanced air pollution control, and systems and equipment. WTI’s clean water group is principally</td>
<td>1,142,219</td>
</tr>
</tbody>
</table>
involved in design, manufacture, operation, and ownership of facilities and systems used to purify water, to treat municipal and industrial wastewater, and to recycle organic wastes into compost material useable for horticultural and agricultural purposes.

International waste management

| Solid and hazardous waste management and related environmental services in ten countries in Europe and in Argentina, Australia, Brazil, Brunei, Hong Kong, Indonesia, Israel, Malaysia, New Zealand, Taiwan, and Thailand. Also has 20 percent interest in Wessex Water Plc, an English publicly traded company providing water treatment, water distribution, wastewater treatment, and sewerage services. |
|---|---|---|
| 1,411,211 | 1,710,862 | 1,865,081 |

Consolidated

| Revenue* |
|---|---|---|
| 8,636,116 | 9,554,705 | 10,274,617 |

*Intercompany revenue eliminations in 1993, 1994, and 1995, respectively, were as follows: $(316,344), ($388,470), ($353,309).

Several of Waste Management’s other businesses (including its hazardous waste management business and several international operations) were also performing poorly. After a strategic review that began in 1994, the company was reorganized into four global lines of business: waste services, clean energy, clean water, and environmental and infrastructure engineering and consulting.  

In the summer of 1996, Dean Buntrock, who founded Waste Management in 1968, retired as CEO, but he continued to serve as chairman of the Board of Directors. Buntrock was initially replaced by Phillip Rooney, who had started working at Waste Management in 1969. In early 1997, Rooney resigned as director and CEO because of mounting shareholder discontent.

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362 1995 10-K.
After a new five-month search, Waste Management chose Ronald LeMay, the president and COO of Sprint, to assume its post of chairman and CEO. Surprisingly, just three months into his new role, LeMay quit to return to his former job at Sprint.

In addition, several other key executives who, unlike LeMay, had worked for Waste Management for several years—including CFO James Koenig, corporate controller Thomas Hau, and vice president of finance Bruce Tobecksen—also resigned by the end of 1997.

**Capitalization of Landfill Costs and Other Expenses**\(^{363}\)

Waste Management capitalized the costs related to obtaining the required permits to develop and expand its many landfills. It also capitalized interest on landfill construction costs, as well as costs related to systems development.

**GAAP for Capitalizing Costs**

Under GAAP, a cost can be capitalized if it provides economic benefits to be used or consumed in future operations. A company is required to write off, as a current period expense, any deferred costs at the time the company learns that the underlying assets have either been impaired or abandoned. Any costs to repair or return property to its original condition are required to be expensed when incurred. Finally, interest can be capitalized as part of the cost of acquiring assets for the period of time that it takes to put the asset in the condition required for its intended use. However, GAAP requires that the capitalization of interest must cease once the asset has become substantially ready for its intended use.

**Capitalization of Landfill Permitting Costs**

As part of its normal business operations, Waste Management allocated substantial resources toward the development of new landfills and the expansion of existing landfills. A significant part of the landfill development and expansion costs related to the process of obtaining required permits from the appropriate government authorities. Over the years, the company faced increased difficulty in obtaining the required landfill permits; it often was faced with having invested significantly in projects that had to be abandoned or materially impaired.

The company routinely capitalized the costs related to obtaining the required permits, so that it could defer

recording expenses related to that landfills until they were put in productive use. However, instead of writing off the costs related to impaired and abandoned landfill projects, and disclosing the impact of such write-offs, management only disclosed the risk of future write-offs related to such projects.

The management team of Waste Management also allegedly engaged in transferring the costs of unsuccessful efforts to obtain permits for certain landfill sites to other sites that had received permits or other sites for which they were still seeking permits. In effect, they were commingling impaired or abandoned landfill project costs with the costs of a permitted site (a practice known as “bASKeting”, which did not comply with GAAP). In addition to basketing, the company also allegedly engaged in transferring unamortized costs from landfill facilities that had closed earlier than expected to other facilities that were still in operation (a practice known as “bundling”, which also did not comply with GAAP). Management never disclosed the use of bundling or basketing in its form 10K.

In 1994, after its auditor Arthur Andersen discovered these practices, management agreed to write off $40 million related to “dead” projects over a span of ten years; management also promised to write off future impairments and abandonments in a prompt manner. However, during 1994, 1995, 1996, and 1997, management effectively “buried” the write-offs related to abandoned and impaired projects by “netting” them against other gains, as opposed to identifying the costs separately.

**Capitalization of Interest on Landfill Construction Costs**

In accordance with GAAP, Waste Management was able to capitalize interest related to landfill development because of the relatively long period of time required to obtain permits, construct the landfill, and, ultimately, prepare it to receive waste. However, Waste Management utilized a method, referred to as the net book value (NBV) method that, essentially, enabled it to avoid GAAP’s requirement that interest capitalization cease once the asset became substantially ready for its intended use. Waste Management’s auditor, Arthur Andersen, advised the company from its first use of the NBV method (in 1989), that this method did not conform to GAAP.

Corporate controller Thomas Hau even admitted that the method was “technically inconsistent with FAS Statement No. 34 [the controlling GAAP pronouncement] because it included interest [capitalization] related to cells of landfills that were receiving waste.” Yet, the company wrote in the footnotes to its financial statements that “[i]nterest has been capitalized on significant landfills, trash-to-energy plants, and other projects under development in accordance with FAS No. 34.”
Ultimately, the company agreed to utilize a new method, one that conformed to GAAP, beginning January 1, 1994. Corporate controller Thomas Hau and CFO James Koenig allegedly determined that the new GAAP method would result in an increased annual interest expense of about $25 million and therefore, they chose to phase in the new method over a period of three years, beginning in 1995. However, the company appeared to still utilize the NBV method for interest capitalization as of 1997.

**Capitalization of Other Costs**

The company’s management also chose to capitalize other costs, such as systems development costs, rather than record them as expenses in the period in which they were incurred. In fact, they allegedly used excessive amortization periods (10- and 20-year periods for the two largest systems) that did not recognize the impact of technological obsolescence on the useful lives of the underlying systems.

The company’s auditor Arthur Andersen proposed several adjusting journal entries to write off the improperly deferred systems development costs. Andersen also repeatedly advised management to shorten the amortization periods. In 1994, management finally agreed to shorten the amortization periods and to write off financial statement misstatements resulting from improperly capitalized systems costs over a period of five years. During 1995, management changed the amortization periods and wrote off improperly capitalized systems costs by “netting” them against other gains.

**Waste Management’s Fixed Asset Accounting Process**

The major fixed assets of Waste Management’s North American business consisted of garbage trucks, containers, and equipment, which amounted to approximately $6 billion in assets. The second largest asset of the company (after vehicles, containers, and equipment) was land, in the form of the more than one hundred fully operational landfills that the company both owned and operated. Under GAAP, depreciation expense is determined by allocating the historical cost of tangible capital assets (less the salvage value), over the estimated useful life of the assets.

**Unsupported Changes to the Estimated Useful Lives of Assets**

From 1988 through 1996, management allegedly made numerous unsupported changes to the estimated useful lives and/or the salvage values of one or more categories of vehicles, containers, or equipment. Such changes had the effect of reducing the amount of depreciation expense recorded in particular periods. In addition, such changes were recorded as top-side adjustments, at the corporate level (detached from the operating unit level). Most often, the
entries were made during the fourth quarter, and then improperly applied cumulatively from the beginning of the year. It appeared that management never disclosed the changes or their impact on profitability to their investors.\textsuperscript{364}

**Carrying Impaired Land at Cost**

Because of the nature of landfills, GAAP also requires that a company compare a landfill’s cost to its anticipated salvage value, with any difference depreciated over its estimated useful life. Waste Management disclosed in the footnotes to the financial statements in its annual reports that “[d]isposal sites are carried at cost and to the extent this exceeds end use realizable value, such excess is amortized over the estimated life of the disposal site.” However it was later uncovered that Waste Management carried almost all of its landfills on the balance sheet at cost.\textsuperscript{365}

**Auditor Assessment\textsuperscript{366}**

In a letter to the management team dated May 29, 1992, Arthur Andersen’s team wrote, “[i]n each of the past five years the Company added a new consolidating entry in the fourth quarter to increase salvage value and/or useful life of its trucks, machinery, equipment, or containers.” Andersen recommended that the company conduct a “comprehensive, one-time study to evaluate the proper level of [WMNA’s salvage value and useful lives],” and then send these adjustments to the respective WMNA groups. Top management continued to change depreciation estimates at headquarters, however.

In March 1994, Executive Vice President and CFO James Koenig, who had worked as an auditor at Arthur Andersen before joining Waste Management in 1977, allegedly instructed a purchasing agent to draft a memo concluding that the agent supported one of the company’s salvage value estimates. In November 1995, a study was initiated to determine the appropriate lives and salvage values of the company’s vehicles, equipments, and containers. Koenig allegedly ordered the study to be stopped after he was informed that the interim results of the study revealed that the company’s salvage values should be reduced. Koenig also was said to have ordered the destruction of all copies of the memo that released the study’s interim results and that the document be deleted from

\footnotesize\textsuperscript{364} SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning), www.sec.gov/litigation/complaints/complr17435.htm.

\footnotesize\textsuperscript{365} Ibid.

\footnotesize\textsuperscript{366} Ibid.
the author’s hard drive. The memo was never provided to the company’s auditors.

Regarding the issue of Waste Management’s treatment of landfills on the balance sheet, Andersen issued a management letter to the Board of Directors recommending that the company conduct a “site by site analysis of its landfills to compare recorded land values with its anticipated net realizable value based on end use” after its 1988 audit. Andersen further instructed that any excess needed to be amortized over the “active site life” of the landfill. Andersen made similar demands after its audit in 1994. Despite this letter, management never conducted such a study and they also failed to reduce the carrying values of overvalued land, despite their commitment to do so after Andersen’s audit in 1994.

**Top-Side Adjusting Journal Entries**

Top-side adjusting journal entries are typically made by upper managers at the end of the reporting process, usually at corporate headquarters. Because these journal entries are typically not generated at the business process (e.g., internet sales) or the business unit level (e.g., the North American Division), they can be used as a way for upper managers to circumvent the internal control system and possibly perpetrate a fraud.

Waste Management seemed to use top-side adjusting entries when consolidating the results of several of its business units and entities in which the company had an interest, to prepare its annual and quarterly financial statements. Indeed, Waste Management’s use of several unbudgeted and unsupported top-side adjustments in the early 1990s caused observers (including Arthur Andersen) to question whether management had employed these adjustments as tools to help “manage” their reported earnings.

Waste Management set its earnings’ targets during an annual budget process. The company followed a “top down budgeting process,” whereby the CEO (Buntrock until 1996, Rooney from Buntrock’s retirement until early 1997) set goals for earnings growth and the operating units would, in turn, determine their budgets based on the goals set at the top. The budgets were then consolidated to arrive at the budgeted consolidated earnings. At this time, the upper managers also set budgets for the anticipated top-side adjustments, which were based on the existing accounting assumptions used.

As operating results were recorded by Waste Management’s operating units at the end of each quarter, upper management allegedly monitored the gap between the results and the goals and made a number of different types of unbudgeted top-side adjusting entries to “close the gap.” Management did not disclose to investors the impact of the
top-side adjustments on the company’s earnings. In fact, management did not inform its own internal operating units about the top-side adjusting entries that were made and their resulting expense reductions.

As early as 1992, the company’s auditor Arthur Andersen advised management against its use of top-side adjusting entries as a tool to manage its earnings in a postaudit letter recommending accounting changes. Andersen auditors wrote that “individual decisions are not being evaluated on the true results of their operations” as a result of the extensive use of top-side adjustments. Andersen recommended that “all such corporate adjustments should be passed back to the respective” divisions. Yet, top management allegedly increased the budget for the top-side adjustments from 1992 to 1997, and, each year, the actual adjustments made exceeded the budgeted adjustments. From the first quarter of 1992 through the first quarter of 1997, top management used unsupported top-side adjustments in 14 of the 21 quarters to achieve reported results that ultimately fell within the range of the company’s public earnings’ projections or its internal budgeted earnings.

In February 1998, Waste Management announced that it was restating the financial statements it had issued for the years 1993 through 1996. In its restatement, Waste Management said that it had materially overstated its reported pretax earnings by $1.43 billion and that it had understated elements of its tax expense by $178 million. When the company’s improper accounting was revealed, the stock dropped by more than 33 percent and shareholders lost over $6 billion.

**Waste Management’s Relationship with Independent Auditor Arthur Andersen**

Even before Waste Management became a public company in 1971, Arthur Andersen served as the company’s auditor. In the early nineties, Waste Management capped Andersen’s corporate audit fees at the prior year’s level, although it did allow the firm to earn additional fees for “special work.” Between 1991 and 1997, Andersen billed Waste Management approximately $7.5 million in audit fees. ¹³ During this seven-year period, Andersen also billed Waste Management $11.8 million in fees related to the following services: $4.5 million for audit work under ERISA, special purpose letters (EPA), franchise audits and other reports, registration statements and comfort letters, International Public Offering, SFAS 106 and 109 adoption, accounting research/discussions and other (audit

committee meetings); $4.5 million for various consulting services that included $450,000 for information systems consulting; and $1.1 million for miscellaneous other services.\textsuperscript{368}

During the nineties, approximately 14 former Andersen employees worked for Waste Management.\textsuperscript{369} While at Andersen, most of these individuals worked in the group responsible for auditing Waste Management’s financial statements prior to 1991, and all but a few had left Andersen more than ten years before the 1993 financial statement audit commenced.\textsuperscript{370}

In fact, until 1997, every chief financial officer (CFO) and chief accounting officer (CAO) at Waste Management since it became public had previously worked as an auditor at Andersen. Waste Management’s CAO and corporate controller from September 1990 to October 1997, Thomas Hau, was a former Andersen audit engagement partner for the Waste Management account. At the time Hau left Andersen, he was the head of the division within Andersen responsible for conducting Waste Management’s annual audit, but he was not the engagement partner at that time.\textsuperscript{371}

**Andersen’s Engagement Partners on Waste Management Audit**

In 1991, Andersen assigned Robert Allgyer, a partner at Andersen since 1976, to become the audit engagement partner for the Waste Management audit engagement. He held the title of “Partner-in-Charge of Client Service” and served as marketing director for Andersen’s Chicago office. Among the reasons for Allgyer’s selection as engagement partner: his “extensive experience in Europe” his “devotion to client service” and his “personal style that … fit well with the Waste Management officers.”\textsuperscript{372} In setting Allgyer’s compensation, Andersen took into account fees for audit and nonaudit services.\textsuperscript{373} Walter Cercavschi, who was a senior manager when he started working on the Waste Management engagement team in the late eighties, remained on the engagement after becoming partner in


\textsuperscript{371} Ibid.

\textsuperscript{372} Ibid.

\textsuperscript{373} Ibid.
In 1993, Edward Maier became the concurring partner on the engagement. As concurring partner, Maier’s duties included reading the financial statements; discussing significant accounting, auditing, or reporting issues with the engagement partner; reviewing certain working papers (such as the audit risk analysis, final engagement memoranda, summaries of proposed adjusting, and reclassifying entries); and inquiring about matters that could have a material effect on the financial statements or the auditor’s report. Maier also served as the risk management partner for the Chicago office in charge of supervising such processes as client acceptance and retention decisions.374

**Andersen’s Proposed Adjusting Journal Entries**

In early 1994, the Andersen engagement team quantified several current and prior period misstatements and prepared Proposed Adjusting Journal Entries (PAJEs) in the amount of $128 million for the company to record in 1993. If recorded, this amount would have reduced net income before special items by 12 percent. The engagement team also identified accounting practices that gave rise to other known and likely misstatements primarily resulting in the understatement of operating expenses.375

Allgyer and Maier consulted with Robert Kutsenda, the Practice Director responsible for Andersen’s Chicago, Kansas City, Indianapolis, and Omaha offices. Kutsenda and the Audit Division head, who was also consulted, determined that the misstatements were not material and that Andersen could, therefore, issue an unqualified audit report on the 1993 financial statements. Nevertheless, they instructed Allgyer to inform management that Andersen expected the company to change its accounting practices and to reduce the cumulative amount of the PAJEs in the future.376 After consulting with the Managing Partner of the firm, Allgyer proposed a “Summary of Action Steps” to reduce the cumulative amount of the PAJEs, going forward, and to change the accounting practices that gave rise to the PAJEs, and to the other known and likely misstatements.377

Although the company’s management agreed to the Action Steps, the company allegedly continued to engage in

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374 Ibid.
375 Ibid.
376 Ibid.
377 Ibid.
the accounting practices that gave rise to the PAJEs, and the other misstatements. Nevertheless, Andersen’s engagement team issued unqualified audit reports on Waste Management’s financial statements, despite its failure to conform to GAAP. In fact, Waste Management’s financial statements for the years 1993 through 1996 overstated the company’s pre-tax income by more than $1 billion.\textsuperscript{378}

* * *

The SEC brought charges against founder Buntrock and five other former top officers on charges of earnings management fraud. The SEC’s charges alleged that top management had made several “top-side” adjustments in the process of consolidating the results reported by each of their operating groups and intentionally hid these adjustments from the operating groups themselves. In addition, top management had allegedly employed several other improper accounting practices to reduce expenses and artificially inflate earnings.\textsuperscript{379}

To help conceal the intentional understatement of expenses, top management allegedly used a practice known as “netting,” whereby one-time gains realized on the sale or exchange of assets were used to eliminate unrelated current period operating expenses, as well as accounting misstatements that had accumulated from prior periods. Top management also allegedly made use of “geography entries”, which involved moving millions of dollars to different line items on the income statement to make it harder to compare results across time. In addition, management allegedly made or authorized false and misleading disclosures in financial statements.\textsuperscript{380}

Because the financial statements for the years 1993 through 1996 were not presented in conformity with GAAP, Waste Management’s independent auditor, Arthur Andersen, came under fire for issuing unqualified opinions on these financial statements. The SEC filed suit against Andersen on charges that it knowingly or recklessly issued materially false and misleading audit reports for the period 1993 through 1996. Andersen settled with the SEC for $7


\textsuperscript{379} SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).

\textsuperscript{380} Ibid.
million, the largest-ever civil penalty at the time, without admitting or denying any allegations or findings.\textsuperscript{381}

Three Andersen partners who worked on the Waste Management audit during the period 1993 through 1996 were implicated in the SEC’s charges: Robert Allgyer, the partner responsible for the Waste Management engagement; Edward Maier, the concurring partner on the engagement and the risk management partner for Andersen’s Chicago office; and Walter Cercavschi, a partner on the engagement. Allgyer, Maier, and Cercavschi agreed to pay a civil money penalty of $50,000, $40,000, and $30,000, respectively. Allgyer, Maier, and Cercavschi were also denied privileges of practicing before the SEC as an accountant, with the right to request reinstatement after five years, three years, and three years, respectively. A fourth Andersen partner, Robert Kutsenda, the Central Region Audit Practice Director responsible for Andersen’s Chicago, Kansas City, Indianapolis, and Omaha offices, was also implicated in the SEC charges for improper conduct. Kutsenda was penalized by being denied the privilege of practicing before the SEC as a accountant. Kutsenda was given the right to request reinstatement after one year.\textsuperscript{382}

\textbf{Comprehensive List of Case Questions}

1. Please consult Paragraph 32 of PCAOB Auditing Standard No. 2. In what ways was Arthur Andersen’s independence, in fact or in appearance, potentially impacted on the Waste Management audit, if any?

2. Considering the example in the Waste Management case, please explain why a review by the Practice Director and the Audit Division Head is important in the operations of a CPA firm. In your opinion, was this review effective in the present context, at Waste Management? Why or why not?

3. Please explain what is meant by PAJE’s. Do you believe that Andersen’s final decision regarding the PAJE’s was appropriate, under the circumstances? Would your opinion change if you knew that all of the adjustments were based on subjective differences (e.g., a difference in the estimate of the allowance for doubtful accounts), as compared to objective differences (e.g., a difference in the account receivable balance of their biggest customer)?


4. Please refer to Section 203 and Section 206 of SOX. How would these sections of the law have impacted the Waste Management audit? Do you believe that these sections were needed? Why or why not?

5. Based on your understanding of inherent risk assessment and the case information, please identify three specific factors about Waste Management that might cause you to elevate inherent risk. When identifying each factor, indicate the financial statement account that is likely to be most affected (and briefly discuss why it is most affected).

6. Consult Paragraphs #71–72 of the PCAOB Auditing Standard No. 2. Next, identify the types of revenue earned (a brief description will do) by Waste Management. Do you believe that any of the different types of revenue earned by Waste Management would have a “different level” of inherent risk? Why or why not?

7. Please consult Q39 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of the different types of revenue earned (in Question #2) would influence the nature, timing, and extent of your audit work at Waste Management.

8. Please consult Paragraphs #24–25 of the PCAOB Auditing Standard No. 2. For one of Waste Management’s revenue sources (choose one), please brainstorm about how a fraud might occur. Next, identify an internal control procedure that would prevent, detect, or deter such a fraudulent scheme.

9. In your own words, please explain what is meant by a “top-side” adjusting journal entry. If you were auditing Waste Management, what type of documentary evidence would you require to evaluate the propriety of a “top-side” journal entry?

10. Please consult Paragraph #16 of PCAOB Auditing Standard No. 2. Based on the case information, do you think this paragraph relates to the use of top-side adjusting journal entries at Waste Management? Why or why not?

11. Consult Paragraphs #76–78 of PCAOB Auditing Standard No. 2. Do you believe that the period-end financial reporting process should always be a significant process in an audit of internal control? Why or why not?

12. Please refer to Paragraphs #84–85 of PCAOB Auditing Standard No. 2. Identify one specific control procedure that could be designed to prevent the occurrence of or detect a misstatement related to a top-side adjusting entry.

13. Please describe why “basketing” and “bundling” are not appropriate under GAAP. As an auditor, what type of evidence would allow you to detect whether your client was engaging in “basketing” or “bundling”?

14. Describe why “netting” would be effective for Waste Management's management team when trying to cover up their fraud. As an auditor, what type of evidence would allow you to detect whether your client was using this
type of practice, designed to mask fraudulent behavior?

15. As an auditor, what type of evidence would you want to examine to determine whether Waste Management was inappropriately capitalizing interest expense and recording the amount as an addition to a fixed assets account?

16. Please consult Paragraph #60 and Paragraphs 68–70 of the PCAOB Auditing Standard No. 2. What is the most relevant financial statement assertion(s) about which financial statement account(s) related to the improper capitalization practices of Waste Management? Why?

17. Under what circumstances is a company allowed to change the useful lives and salvage values of its fixed assets under GAAP? As an auditor, what type of evidence would you want to examine to determine whether Waste Management’s decision to change the useful lives and salvage values of its assets was appropriate under GAAP?

18. Please consult Paragraph #60 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. What is the most relevant financial statement assertion(s) about which financial statement account(s) related to the treatment of depreciation expense on fixed assets at Waste Management?

19. If you were auditing Waste Management in 1995 and you discovered that neither the Board of Directors nor the Management Team conducted a “site by site analysis” of the landfills that you had recommended the year before, what action, if any, would you take? Why?

20. Please consult Paragraph #84 of the PCAOB Auditing Standard No. 2. The paragraph states that “the auditor should clearly link individual controls with the significant accounts and assertions to which they relate.” For the assertion identified in Question #2, please identify a specific internal control activity that would help to prevent or detect a misstatement related to depreciation expense at Waste Management.
Case A.3

WorldCom

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 that 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 underestimation of line costs (by over $7 billion), its largest category of expenses.

The Special Investigative Committee of the Board of Directors found no evidence that WorldCom’s independent auditor, Arthur Andersen, in fact determined that WorldCom’s revenues or line costs were improperly reported. However, they 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.383

Growth through Acquisitions

WorldCom evolved from a long-distance telephone provider named Long Distance Discount Services (LDDS), which had annual revenues of approximately $1.5 billion by the end of 1993. LDDS connected calls between the local telephone company of a caller and the local telephone company of the call’s recipient by reselling long distance capacity it purchased from major long distance carriers (e.g., AT&T, MCI, and Sprint) on a wholesale basis.384 LDDS was renamed WorldCom in 1995.

A change in industry regulation was the primary catalyst for WorldCom’s growth. That is, the Telecommunications Act of 1996 allowed long-distance telephone service providers to enter the market for local

383 Board of Directors’ Special Investigative Committee Report, June 9, 2003, p. 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.”

384 Ibid., 44–45.
telephone services and other telecommunications services, such as the Internet. Like many players in the industry, WorldCom turned to acquisitions to expand into these markets.

WorldCom’s revenues grew rapidly as it embarked on these acquisitions. Between the first quarter of 1994 and the third quarter 1999, WorldCom’s year-over-year revenue growth was over 50 percent in 16 of the 23 quarters; the growth rate was less than 20 percent in only three of the quarters. WorldCom’s stock price experienced rapid growth as well, from $8.17 at the beginning of January 1994 to $47.91 at the end of September 1999 (adjusted for stock splits). Its stock performance exceeded those of its largest industry competitors, AT&T and Sprint.385

**MFS and Subsidiary UUNET**

In late 1996, WorldCom acquired MFS, which provided local telephone services, for $12.4 billion. In that transaction, WorldCom also gained an important part of the Internet backbone through MFS’s recently acquired subsidiary, UUNET.386

**Brooks Fiber Properties, CompuServe Corporation, and ANS Communications**

In 1998, WorldCom purchased Brooks Fiber Properties for approximately $2.0 billion and CompuServe Corporation and ANS Communications (a three-way transaction valued at approximately $1.4 billion that included a five-year service commitment to America Online). Each of these companies expanded WorldCom’s presence in the Internet arena.

**MCI**

In September 1998, WorldCom acquired MCI, using approximately 1.13 billion of its common shares and $7.0 billion cash as consideration, for a total price approaching $40 billion. MCI’s annual revenues of $19.7 billion in 1997 far exceeded WorldCom’s 1997 annual revenues of $7.4 billion. As a result of this merger, WorldCom became the second-largest telecommunications provider in the United States.

**SkyTel Communications and Sprint**

In October 1999, WorldCom purchased SkyTel Communications, adding wireless communications to its service offerings, for $1.8 billion. A few days after its SkyTel acquisition, WorldCom announced that it would merge with

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385 Ibid., 48.
386 Ibid., 46.
Sprint in a deal valued at $115 billion. In the proposed deal, WorldCom would gain Sprint’s PCS wireless business, in addition to its long distance and local calling operations.\(^{387}\)

**Challenges**

By 2000, WorldCom started to face some difficult challenges. For starters, it faced fierce competition in its industry. In addition, its proposed merger with Sprint failed to receive approval from the Antitrust Division of the United States Department of Justice. The companies officially terminated their discussions on July 13, 2000.\(^{388}\)

Although WorldCom’s revenue continued to grow, the rate of growth slowed. On November 1, 2000, it announced the formation of two tracking stocks: one—called WorldCom Group—to capture the growth of its data business, and the other—called MCI—to capture the cash generation of its voice business, which experienced low growth. WorldCom also announced reduced expectations for revenue growth of the consolidated company, from its previous guidance of 12 percent to between 7 percent and 9 percent in the fourth quarter of 2000 and all of 2001. By the close of market on the day of its announcement, WorldCom’s stock price had fallen by 20.3 percent, from $23.75 on October 31, 2000, to $18.94.\(^{389}\)

Industry conditions worsened in 2001. Both the local telephone services and Internet segments experienced downturns in demand. The impact of the downturn in the Internet segment was particularly severe because of the industry’s increased investment in network capacity (supply). Many competitors found themselves mired in long-term contracts that they had entered into to obtain the capacity to meet anticipated customer demand. As the ratio of their expenses to revenues was increasing, industry revenues and stock prices plummeted. For example, the stock prices of WorldCom, AT&T, and Sprint each lost at least 75 percent of its share price value between January 2000 and June 25, 2002.\(^{390}\)

**Independent Auditor’s Risk Assessment**

The Special Investigative Committee of the Board of Directors did find evidence that Andersen understood the

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\(^{387}\) Ibid., 47–48.

\(^{388}\) Ibid., 48–49.

\(^{389}\) Ibid., 50.

\(^{390}\) Ibid., 51–55.
elevated risk associated with the WorldCom audit. Specifically, although Andersen’s System for Managing Acceptance and Retention (SMART) Tool—which assessed the risks of business failure, fraud, and accounting and financial errors—rated WorldCom a “high risk” client, Andersen manually overrode this result and increased WorldCom to a “maximum risk” client. The committee reported that Andersen’s workpapers revealed that the reasoning behind this elevation of risk was “the volatility in the telecommunications industry, the company’s future merger and acquisition plans, and the company’s reliance on a high stock price to fund those acquisitions.”

Surprisingly, Andersen did not disclose to the public that WorldCom was considered a “maximum risk” client to the Audit Committee.392

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 greater audit risk.

The outcome of this discussion after the 1999 and 2000 year-end audits was that Andersen did not find evidence of aggressive accounting or fraud at WorldCom.393 However, during the Expanded Risk Discussion that was held in December 2001, concerns were voiced over WorldCom’s use of numerous “top-side” journal entries. Such entries were 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.394

**Line Cost Expenses**

WorldCom generally maintained its own lines for local service in heavily populated urban areas. However, it relied

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392 Board of Directors’ Special Investigative Committee Report, June 9, 2003, p. 27.


394 Board of Directors’ Special Investigative Committee Report, June 9, 2003, p. 236.
on non-WorldCom networks to complete most residential and commercial calls outside of these urban areas and paid the owners of the networks to use their services. For example, a call from a WorldCom customer in Boston to Rome might start on a local (Boston) phone company’s line, flow to WorldCom’s own network, and then get passed to an Italian phone company to be completed. In this example, WorldCom would have to pay both the local Boston phone company and the Italian provider for the use of their services. The costs associated with carrying a voice call or data transmission from its starting point to its ending point were called *line cost expenses*.

Line cost expenses were WorldCom’s largest single expense. They accounted for approximately half of the company’s total expenses from 1999 to 2001. WorldCom regularly discussed its line cost expenses in public disclosures, emphasizing, in particular, its “line cost E/R ratio,” the ratio of line cost expense to revenue.

**GAAP for Line Costs**

Under Generally Accepted Accounting Principles (GAAP), WorldCom was required to estimate its line costs each month and to expense the estimated cost immediately, even though many of these costs would be paid at a later date. To reflect an estimate of amounts that had not yet been paid, WorldCom would set up a liability account, known as an *accrual*, on its balance sheet. As the bills arrived from its outside parties, sometimes many months later, WorldCom would pay them and reduce the previously established accruals accordingly.

Because accruals are estimates, a company was required under GAAP to reevaluate them periodically to see if they were stated at appropriate levels. If charges from service providers were lower than estimated, an accrual was “released.” The amount of the release was set off against the reported line cost expenses in the period when the release occurred. For example, if an accrual of $500 million was established in the first quarter and $25 million of that amount was deemed excess or unnecessary in the second quarter, then $25 million should be released in that second quarter and, thus, result in reducing reported line cost expenses by $25 million.

**WorldCom’s Line Cost Releases**

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395 Board of Directors’ Special Investigative Committee Report, June 9, 2003, p. 58.

396 Ibid., 58–59.

397 Ibid., 62–63.

398 Ibid., 63–64.
Beginning in the second quarter of 1999, management allegedly started ordering several releases of line cost accruals, often without any underlying analysis to support the releases. When requests were met with resistance, management allegedly made the adjustments themselves. For example, in the second quarter of 2000, David Myers, a CPA who served as senior vice president and controller of WorldCom, requested that UUNET (a largely autonomous WorldCom subsidiary at the time) release $50 million in line cost accruals. UUNET’s acting Chief Financial Officer David Schneeman, asked that Myers explain the reasoning for the requested release, but Myers insisted that Schneeman book the entry without an explanation. When Schneeman refused, Myers wrote him in an e-mail: “I guess the only way I am going to get this booked is to fly to DC and book it myself. Book it right now, I can’t wait another minute.” After Schneeman refused again, Betty Vinson in general accounting allegedly completed Myers’ request by making a “top-side” corporate-level adjusting journal entry releasing $50 million in UUNET accruals.  

In 2000, senior members of WorldCom’s corporate finance organization reportedly directed a number of similar releases from accruals established for other reasons to offset domestic line cost expenses. For example, in the second quarter of 2000, Senior Vice President and Controller David Myers asked Charles Wasserott, director of Domestic Telco Accounting, to release $255 million in domestic line cost accruals to reduce domestic line cost expenses. Wasserott refused to release such a large amount. It later emerged that the entire $255 million used to reduce line cost expenses came instead from a release of a Mass Markets accrual related to WorldCom’s Selling General & Administrative expenses.

The largest of the releases of accruals from other areas to reduce line cost expenses occurred after the close of the third quarter of 2000. During this time, a number of entries were made to release various accruals that reduced domestic line cost expenses by $828 million.

In addition to releasing line cost accruals without proper support for doing so and releasing accruals that had been established for other purposes, it was also alleged that WorldCom management had not released certain line costs in the period in which they were identified. Rather, certain line cost accruals were kept as “rainy day” funds,

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399 Ibid., 83.
400 Ibid., 87–88.
401 Ibid., 88–89.
which could be released when managers wanted to improve reported results.\footnote{Ibid., 10.}

**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 it viewed its relationship with WorldCom as a “long-term partnership,” in which Andersen would help WorldCom improve its business operations and growth in the future. In its Year 2000 audit proposal, Andersen told the Audit Committee that it considered itself “a committed member of [WorldCom’s] team” and that WorldCom was “a flagship client and a ‘crown jewel’” of its firm.\footnote{Board of Directors’ Special Investigative Committee Report, June 9, 2003, p. 225.}

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.\footnote{Board of Directors’ Special Investigative Committee Report, June 9, 2003, p. 225.}

**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 allegedly instructed him not to give Andersen access to this reporting system.\footnote{Board of Directors’ Special Investigative Committee Report, June 9, 2003, pp. 246–248.}

In addition, WorldCom’s senior management 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 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 to the accountant: 406

Do not have anymore 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. 407

Audit Approach

The Special Investigative Committee of the Board of the Directors found that Andersen relied heavily on substantive analytical procedures and conducted only a limited amount of detailed substantive testing. Andersen’s audit approach relied heavily on analytical procedures, without taking into full account the possibility that management may be manipulating the results to eliminate significant financial statement variations. Further, Andersen 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. In addition, Andersen’s testing of capital expenditures, line costs, and revenues did not change materially from 1999 through 2001. 408

The Special Committee was surprised by Andersen’s failure to detect significant deficiencies in WorldCom’s procedures related to the proper documentary support of “top-side” accounting entries. For example, the committee found hundreds of large, round-dollar journal entries that were made by WorldCom’s General Accounting group staff, without any support other than a Post-it® Note or written instruction directing the entry to be made. The

408 Board of Directors’ Special Investigative Committee Report, June 9, 2003, p. 228.
Measurement and Monitoring of Revenue within WorldCom

Revenue growth was said to have been particularly emphasized within WorldCom. On a regular basis, the sales groups’ performances were measured against the revenue plan. At meetings held every two to three months, each sales channel manager was required to present and defend his or her sales channel’s performance against the budgeted performance. Compensation and bonus packages for several members of senior management were also tied to double-digit revenue growth. In 2000 and 2001, for instance, three executives were eligible to receive an executive bonus only if the company achieved double-digit revenue growth over the first six months of each year.410

Monthly Revenue Report (“MonRev”) and the Corporate Unallocated Schedule

The principal tool by which revenue performance was measured and monitored at WorldCom was the monthly revenue report (“MonRev”) prepared and distributed by the revenue reporting and accounting group (hereafter referred to as the revenue accounting group). The “MonRev” included dozens of spreadsheets detailing revenue data from all of the company’s channels and segments. The full MonRev contained the Corporate Unallocated schedule, an attachment detailing adjustments made at the corporate level and generally not derived from the operating activities of WorldCom’s sales channels. WorldCom’s Chief Financial Officer and Treasurer Scott Sullivan had ultimate responsibility for the items booked on the Corporate Unallocated schedule.411

In addition to CEO Ebbers and CFO Sullivan, only a handful of employees outside the revenue accounting group regularly received the full MonRev. Most managers at WorldCom received only those portions of the MonRev that were deemed relevant to their position; for example, most sales channels managers received only those components of the MonRev that reflected their own sales channel revenue information. It was alleged that Sullivan


410 Ibid., 133–134.

411 Ibid., 135–139.
routinely reviewed the distribution list for the full MonRev to make sure he approved of everyone on the list.\textsuperscript{412}

The total amounts reported in the Corporate Unallocated schedule usually spiked during quarter-ending months, with the largest spikes occurring in those quarters when operational revenue lagged furthest behind quarterly revenue targets—the second and third quarters of 2000 and second, third, and fourth quarters of 2001. Without the revenue booked in Corporate Unallocated, WorldCom would have failed to achieve the double-digit growth it reported in 6 out of 12 quarters between 1999 and 2001.\textsuperscript{413}

In 1999 and 2000, the Revenue Accounting group attempted to track the impact of Corporate Unallocated and other accounting adjustments by generating two MonRevs—one that represented the company’s operational revenues before any adjustments and a second representing the revenues as supplemented by any extraordinary accounting entries, such as those recorded in the Corporate Unallocated revenue account. The “Extraordinary Revenue Items” schedule captured the items that comprised the difference between the two documents. The group decided to stop preparing both reports, a decision they later said was principally based on the time required to produce the second version of the MonRev, given the limited resources in his group.\textsuperscript{414}

**Process of Closing and Consolidating Revenues**

WorldCom maintained a fairly automated process for closing and consolidating operational revenue numbers. By the tenth day after the end of the month, revenue accounting group prepared a draft “Preliminary MonRev” that was followed by a Final MonRev, which took into account any adjustments that needed to be made. In nonquarter-ending months, the Final MonRev was usually similar, if not identical, to the Preliminary MonRev.\textsuperscript{415}

In quarter-ending months, however, revenue accounting entries, often large, were made during the quarterly close to hit revenue growth targets. Investigators later found notes made by senior executives in 1999 and 2000 that calculated the difference between “actual” or “MonRev” results and “target” or “need[ed]” numbers, and identified the entries that were necessary to make up that difference. It was alleged that CFO Scott Sullivan directed this

\textsuperscript{412} Ibid., 135–139.

\textsuperscript{413} Ibid., 135–139.

\textsuperscript{414} Ibid., 140–141.

\textsuperscript{415} Ibid., 140–141.
process, which was implemented by Ron Lomenzo, the Senior Vice President of Financial Operations, and Lisa Taranto, an employee who reported to Lomenzo.\footnote{Ibid., 14.}

Throughout much of 2001, WorldCom’s revenue accounting group tracked the gulf between projected and targeted revenue—an exercise labeled “Close the Gap”—and kept a running tally of accounting “opportunities” that could be exploited to help make up that difference.\footnote{Ibid., 141.}

Many questionable revenue entries were later found within the Corporate Unallocated revenue account. On June 19, 2001, as the quarter of 2001 was coming to a close, CFO Sullivan left a voicemail for CEO Ebbers that indicated his concern over the company’s growing use of nonrecurring items to increase revenues reported:

Hey Bernie, it’s Scott. This MonRev just keeps getting worse and worse. The copy, um the latest copy that you and I have already has accounting fluff in it … all one time stuff or junk that’s already in the numbers. With the numbers being, you know, off as far as they are, I didn’t think that this stuff was already in there…. We are going to dig ourselves into a huge hole because year to date it’s disguising what is going on the recurring, uh, service side of the business….\footnote{Ibid., 15.}

A few weeks later, Ebbers sent a memorandum to WorldCom’s COO Ron Beaumont that directed him to “see where we stand on those one time events that had to happen in order for us to have a chance to make our numbers…. Yet, Ebbers did not give any indication of the impact of nonrecurring items on revenues in his public comments to the market in that quarter or in other quarters. For that matter, the company did not address the impact of nonrecurring items on revenues in its earnings release or public filing for that quarter or prior quarters as well.\footnote{Ibid., 15.}

* * *

By the first quarter of 2002, management realized it was virtually impossible to deliver double-digit revenue growth. During a February 7, 2002, analyst call, CEO Ebbers announced guidance of “mid single-digits” revenue growth. Soon thereafter, both Ebbers and CFO Sullivan expressed confidence in achieving 5 percent revenue growth.
Two weeks later, Ebbers was provided with an internal review of January 2002 revenue numbers, which showed that even those projections were ambitious; that is, January MonRev results showed a 6.9 percent year-over-year decline in revenue. In the first quarter of 2002, the WorldCom Group ultimately reported revenues of $5.1 billion, a decline of approximately 2 percent from the first quarter of 2001. This publicly reported decline in revenue occurred despite the fact that approximately $132 million was booked in the WorldCom Group Corporate Unallocated revenue account in the first quarter of 2002.\footnote{420}

**Internal Audit Department**

The Audit Committee of the Board of Directors at WorldCom had responsibility for ensuring that the company’s systems of internal controls were effective. The Internal Audit Department periodically gathered information related 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.”\footnote{421}

However, the bankruptcy examiner also wrote that he 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.\footnote{422}

WorldCom’s internal audit department focused its audits primarily on the areas that were expected to yield cost savings or result in additional revenues.\footnote{423} 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.

\footnote{420}{Ibid., 155.}

\footnote{421}{Second Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, June 9, 2003, p. 12.}

\footnote{422}{Ibid., 174–176.}

\footnote{423}{Ibid., 186–187.}
The SEC’s investigation revealed that management’s influence over the activities of the internal audit department appeared to supersede 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.  

**Internal Audit Department’s Relationship with Management**

Although the Audit Committee annually approved the audit plans of the internal audit department, it 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 play any role in determining the day-to-day activities of the internal audit department. That responsibility appeared to belong to the CFO, who provided direction over the development of the scope of the department’s audits and 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.

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 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.

At times, CFO Sullivan or CEO Ebbers would assign 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.

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424 Ibid., 194–195.
425 Ibid., 194–195.
426 Ibid., 190–191.
427 Ibid., 195–197.
428 Ibid., 190–191.
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 the Audit Committee 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 $161,000.429

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.430

Lack of Substantive Interaction with External Auditors

Arthur Andersen’s annual statement to the Audit Committee noted no material 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 that there was no communication between the internal and the external auditors to ensure awareness about all of the internal control weaknesses that were discovered. In fact, after 1997, internal audit had few substantive interactions with the company’s external auditors other than at the quarterly Audit Committee meetings, where both groups made presentations.431

Restricted Access to Information

429 Ibid., 192–193.

430 Ibid., 192–193.
The internal audit department lacked consistent support throughout the company. In many instances, management allegedly refused to answer or dodged certain questioned asked by internal audit personnel. In several cases, internal audit personnel would have to make repeated requests for information, and their requests were not always furnished in a timely manner.\(^{432}\)

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 the company’s reporting system, and the company’s general ledgers.\(^{433}\)

**Comprehensive List of 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 the 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.

5. Based on your understanding of inherent risk assessment and the case information, please identify three specific factors about WorldCom’s strategy within its industry that might cause you to elevate inherent risk.

\(^{431}\) Ibid., 193–194.

\(^{432}\) Ibid., 195–197.

\(^{433}\) Ibid., 195–197.
6. Please consult Q39 and Q43 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of the inherent risks identified at WorldCom (in Question #1) would influence the nature, timing, and extent of your audit work at WorldCom.

7. Please consult Paragraphs B1 and B6 in Appendix B of the Internal Control Standard. If you were conducting an internal control audit of WorldCom, comment about how WorldCom’s acquisition strategy would impact the nature, timing, and extent of your audit work at WorldCom.

8. Based on your understanding of fraud risk assessment, what are the three conditions that are likely to be present when a fraud occurs? Based on the information provided in the case, which of these three conditions appears to be most prevalent, and why?

9. Consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Please define what is meant by control environment. Why does the control environment have a “pervasive” effect on the reliability of financial reporting at an audit client like WorldCom?

10. Consider Paragraph #63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Please identify one relevant financial statement assertion related to the revenue account that is impacted by corporate unallocated revenue activity. Why is it relevant?

11. Please explain what is meant by a “top-side” adjusting journal entry. If you were auditing WorldCom, what type of documentary evidence would you require to evaluate the propriety of a “top-side” journal entry made to the revenue account?

12. Please consult Q38 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of WorldCom’s control environment and other company level controls would help you implement a “top-down” approach to an internal control audit at WorldCom.

13. Consider Paragraph #25 of PCAOB Auditing Standard No. 2. For WorldCom’s corporate unallocated revenue activity, discuss an internal control procedure that would help to prevent, detect, or deter fraud related to the corporate unallocated revenue activity.

14. Consult Paragraph #24 of the 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?

15. 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?

16. Please consult Paragraph #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?

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

18. 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?).

19. Describe what is meant by “releasing” line costs. If you were working as an accountant for WorldCom and there was a legitimate basis to “release” certain line costs, what is the journal entry that would be required to “release” a line cost?

20. Please refer to Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Identify one relevant financial statement assertion related to the line cost expenses account. Why is it relevant? Next, identify one relevant financial statement assertion related to the accrued line cost liability account. Why is it relevant?

21. As an auditor at WorldCom, what type of evidence would you want to examine to determine whether a company was inappropriately “releasing” line costs?

22. Please refer to Paragraph #25 of PCAOB Auditing Standard No. 2. This paragraph requires management to design and implement controls to prevent, deter, and detect fraud. For WorldCom’s line cost financial reporting process, please discuss an internal control activity that would help to prevent, detect, or deter fraud related to the “releasing” of line costs.
Case A.4

Sunbeam

Following several quarters of disappointing sales and earnings results, CEO and Chairman Roger Schipke tendered his resignation in April 1996. The company named as Schipke’s successor Albert J. Dunlap, chief of Scott Paper Co. and a turnaround specialist nicknamed “Chainsaw Al” because of the cost-cutting measures he typically employed.

Dunlap began his tenure as CEO and chairman by replacing almost all of top management, and then led the company in an aggressive corporate restructuring that included the elimination of half of the company’s 12,000 employees and the elimination of 87 percent of Sunbeam’s product list. Sunbeam’s turnaround was ultimately unsuccessful. CEO and Chairman Dunlap was fired in June 1998.


Sunbeam’s History

The early beginnings of Sunbeam Corporation could be traced back to the Chicago Flexible Shaft Company, founded by John Stewart and Thomas Clark in 1897. Although it was not until 1946 that the company changed its name to Sunbeam, it adopted the name Sunbeam in its advertising shortly after it expanded into manufacturing electrical appliances in 1910.

Successful products in the 1930s included the Sunbeam Mixmaster, a stationary food mixer; the Sunbeam Shavemaster Shaver, the first automatic coffeemaker; and the first pop-up electric toaster. Later appliances included the hair dryer (1949), humidifier (1950), ice crusher (1950), knife sharpener (1950), the Sunbeam Egg Cooker (1950), the Sunbeam Controlled Heat fry pan (1953), and an electric blanket (1955). The company acquired rival household appliance maker Oster in 1960.


435 Hoovers Online.
In 1981, Sunbeam was acquired by industrial conglomerate Allegheny International, which fell into bankruptcy in 1988 because of economic difficulties in its other divisions. Michael Price, Michael Steinhardt, and Paul Kazarian bought Allegheny from its creditors in 1990 and named the company Sunbeam-Oster. Kazarian assumed the positions of CEO and chairman. Under Kazarian’s leadership, the company paid off its debt, reorganized operations, and cut its workforce dramatically.436

The company went public in 1992. Mr. Kazarian was forced out in 1993 and replaced by Roger Schipke, a former manager of General Electric’s appliance division. Kazarian was subsequently awarded $160 million in a lawsuit he filed for being forced out. The company was renamed Sunbeam in 1995. That year, the company faced stagnant product prices and other difficult industry conditions, such as the growth of discount chains. In the face of these conditions, Sunbeam introduced new product lines, made acquisitions, and invested in greater production capacity.437 After several quarters of disappointing sales and earnings results, Schipke tendered his resignation in April 1996. The company named as Schipke’s successor Albert J. Dunlap, chief of Scott Paper Co.

**Sunbeam in 1996**

Sunbeam Corporation had five major product lines in its domestic operations: household appliances, health care products, personal care and comfort products, outdoor cooking products, and “away from home” business. It also had international sales that accounted for approximately 19 percent of its total net sales.438

Household appliances (29 percent of 1996 domestic net sales) included blenders, food steamers, bread makers, rice cookers, coffee makers, toasters, and irons. Examples of health care products (11 percent) were vaporizers, humidifiers, air cleaners, massagers, and blood pressure monitors. Sunbeam’s line of personal care and comfort products (21 percent) included shower massagers, hair clipper and trimmers, and electric warming blankets. Some of its major outdoor cooking products (29 percent) were electric, gas, and charcoal grills, and grill accessories. Its “away from home” business (5 percent) marketed clippers and related products for the professional and veterinarian trade, as well as products to commercial and institutional channels.

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437 Ibid.

438 1996 10K filing to SEC, Item 1 (“Business”).
Executive Leadership

Chairman and CEO Albert J. Dunlap assumed leadership in 1996. Dunlap invested $3 million of his own money in Sunbeam shares. “If I make a lot of money here [at Sunbeam]—which I certainly intend to do—then the shareholders will make a lot… I’m in lockstep with the shareholders.” 439

Dunlap immediately hired Russell Kersh as Sunbeam’s chief financial officer. Dunlap and Kersh both entered into lucrative three-year employment agreements that gave them strong financial incentives to raise the share price of the company. Dunlap then replaced almost all of top management, and their replacements were each provided with strong financial incentives to improve the company’s share price. 440

Corporate Restructuring and Plans for Growth

Under Dunlap’s reign, Sunbeam embarked on an aggressive restructuring that would involve the elimination of half of the company’s 12,000 employees; the sale or consolidation of 39 of its 53 facilities; the divestiture of several lines of businesses, such as its furniture business; the elimination of 87 percent of Sunbeam’s product list; and the replacement of six regional headquarters in favor of a single office in Delray Beach, Florida. “We planned this like the invasion of Normandy…. We attacked every aspect of the business, said Dunlap.” 441

Dunlap publicly predicted that, as a result of the restructuring, the company would attain operating margins of 20 percent of sales in 1997, and increase its sales by 20 percent, 30 percent, and 35 percent, respectively, in 1997, 1998, and 1999. This meant that the company would have to double its sales to $2 billion by 1999. 442 Other goals

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were to introduce 30 new products each year domestically, and to triple international sales to $600 million by 1999.443

Sunbeam’s Restructuring Charges

Associated with its operational restructuring, Sunbeam’s 1996 results included a pretax charge to earnings of $337.6 million, which was allocated as follows:444

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restructuring, Impairment, and Other Costs</td>
<td>$154.9 million</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>$ 92.3 million</td>
</tr>
<tr>
<td>Selling, General, and Administrative (SG&amp;A)</td>
<td>$ 42.5 million</td>
</tr>
<tr>
<td>Estimated Loss from Discontinued Operations</td>
<td>$ 47.9 million</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$337.6 million</strong></td>
</tr>
</tbody>
</table>

Restructuring, Impairment, and Other Costs

The “Restructuring, Impairment, and Other Costs” category included the following cash items: severance and other employee costs ($43.0 million); lease obligations and other exit costs associated with facility closures ($12.6 million); and back office outsourcing start-up costs and other costs related to the implementation of the restructuring and growth plan ($7.5 million). Noncash items in this category ($91.8 million) were related to asset write-downs for disposals of excess facilities and equipment and noncore product lines; write-offs of redundant computer systems from the administrative back-office consolidations and outsourcing initiatives; and intangible, packaging and other asset write-downs related to exited product lines and SKU reductions.

Importantly, this amount also included approximately $18.7 million of items that benefited future activities, for example, costs of redesigning product packaging, costs of relocating employees and equipment, and certain consulting fees.445 Inclusion of these items was not allowed under GAAP.

Cost of Goods Sold, SG&A, and Estimated Loss from Discontinued Operations

443 1996 10K filing to SEC, Item 1 (“Business”).

444 1996 10K filing to SEC. Also see 1997 10K SEC filing, Note 8 (“Restructuring, Impairment, and Other Costs”).

As part of its operational restructuring, Sunbeam sold the inventory of its eliminated products to liquidators at a substantial discount. As such, the Cost of Goods Sold portion of the restructuring charge related principally to inventory write-downs and costs of inventory liquidation programs.

The SG&A portion of the restructuring charge related principally to increases in environmental, litigation, and other reserves. The litigation reserve was created for a lawsuit alleging Sunbeam’s potential obligation to cover a portion of the cleanup costs for a hazardous waste site. To establish a litigation reserve under GAAP, management must determine that the reserved amount reflects a loss that is probable and able to be reasonably estimated. However, Sunbeam management allegedly failed to take sufficient steps to determine what reserve amount would have been appropriate under GAAP.446 Finally, the estimated loss from the discontinued operations portion of the restructuring reserve was related to the divestiture of the company’s furniture business.447

**Using Excess Reserves to Offset Current Expenses**

In the first quarter of 1997, Sunbeam used $4.3 million of these restructuring reserves to offset against costs incurred in that period. This improved Sunbeam’s 1997 income by approximately 13 percent. Sunbeam failed to disclose this “infrequent item” in its quarterly filing. In the second quarter of 1997, Sunbeam offset $8.2 million in second quarter costs against the restructuring and other reserves created at year-end 1996, without making the appropriate disclosures. It made a similar offsets of current period expenses in the third and fourth quarters of 1997: $2.9 million and $1.5 million, respectively.448

**Restatement of Restructuring Charge**

In November 1998, Sunbeam ultimately restated the pretax restructuring charge from $337.6 million to $239.2, which was allocated as follows:449

| Restructuring, Impairment, and Other Costs | $110.1 million |

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447 1996 10K filed with the SEC.


449 Amended 1997 10K filed with the SEC.
### Restructuring, Impairment, and Other Costs

Restructuring, Impairment and Other Costs was restated as follows: severance and other employee costs of $24.7 million; lease obligations and other exit costs associated with facility closures of $16.7 million. Noncash items—related to asset write-downs for disposals of excess facilities, and equipment and noncore product lines; write-offs of redundant computer systems from the administrative back-office consolidations and outsourcing initiatives; and intangible, packaging and other asset write-downs related to exited product lines and SKU reductions—totaled $68.7 million.\(^{450}\)

### Cost of Goods Sold, SG&A, and Estimated Loss from Discontinued Operations

Contributing to the company’s need to restate its Cost of Goods Sold expense related to restructuring stemmed from the fact that, in calculating their estimate for year-end inventory of household products, management failed to distinguish excess and obsolete inventory from inventory that was part of their continuing product lines. Thus, the value of Sunbeam’s inventory from its continuing household product lines had been understated by $2.1 million on its balance sheet. Its restatement to its SG&A included a revision of a $12 million litigation reserve that initially was improperly overstated by at least $6 million.\(^{451}\)

### Sunbeam’s Customer Discounts and Other Incentives

Under GAAP, sales revenue can be recognized only if the buyer assumes the risks and rewards of ownership of merchandise, for example, the risk of damage or physical loss. A sale with a right of return can be recognized as revenue only if the seller takes a reserve against possible future returns. The size of this reserve must be based on history with returns; the sales revenue may not be recorded if no such history exists.

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\(^{450}\) Amended 1997 10K filed with the SEC.

Beginning with the first quarter of 1997, Sunbeam began offering its customers discounts and other incentives if they placed their orders in the current period, rather than holding off until the next period. Sunbeam did not disclose this practice of accelerating expected sales from later periods, however. In the other quarters of 1997, Sunbeam also relied on additional price discounting and other incentives in an attempt to accelerate the recognition of revenue from future periods.452

One example of a special arrangement with a customer took place at the end of March 1997, just before the first quarter closed. Sunbeam recognized $1.5 million in revenue and contributed $400,000 toward net income from the sale of barbecue grills to a wholesaler. The contract with the wholesaler provided that the wholesaler could return all of the merchandise, with Sunbeam paying all costs of shipment and storage, if it was unable to sell it. In fact, the wholesaler wound up returning all of the grills to Sunbeam during the third quarter of 1997, and the wholesaler incurred no expenses in the transaction.453

Bill and Hold Sales

In the second quarter of 1997, Sunbeam recognized $14 million in sales revenue and contributed over $6 million toward net income from “bill and hold” sales. By the fourth quarter, Sunbeam was able to recognize $29 million in revenues and contributed $4.5 million toward net income in bill and hold sales after it began promoting its bill-and-hold program. Bill and hold sales contributed to 10 percent of the fourth quarter’s revenue.454

At year-end 1997, Sunbeam disclosed in its annual filing to the SEC that “the amount of [the] bill and hold sales at December 29, 1997, was approximately 3 percent of consolidated revenues.” It did not disclose that bill and hold sales had been booked primarily in the final quarter to pull revenue from 1998 to 1997.455

Revenue Recognition Criteria for Bill and Hold Sales

The SEC had stipulated that the following criteria must be met for revenue to recognized in bill and hold transactions:456

The risks of ownership must have passed to the buyer.

The buyer must have made a fixed commitment to purchase the goods.

The buyer must request that the transaction be on a bill-and-hold basis, and must have a substantial business purpose for this request.

There must be a fixed schedule for delivery of the goods.

The seller must not have retained any specific performance obligations such that the earning process is not complete.

The ordered goods must be segregated from the seller’s inventory.

The goods must be complete and ready for shipment.

**Characteristics of Sunbeam’s Bill and Hold Sales**

The SEC found that Sunbeam’s bill and hold sales were not requested by Sunbeam’s customers and served no business purpose other than to accelerate revenue recognition by Sunbeam. Sunbeam’s bill and hold sales were typically accompanied by financial incentives being offered to customers, such as discounted pricing, to encourage the “sale” to occur long before the customer actually needed the goods. Sunbeam would then hold the product until delivery was requested by the customer. Sunbeam also paid the costs of storage, shipment, and insurance related to the products. In addition, Sunbeam’s customers had the right to return the unsold product.\(^{457}\)

**Sales to Distributors**

In December 1997, Sunbeam devised a “distributor program” that would help improve the company’s sales in 1997. Sunbeam accelerated recognition of sales revenue for merchandise it placed with distributors in advance of actual retail demand. Sunbeam used favorable payment terms, discounts, guaranteed mark-ups, and, consistently, the right to return unsold product as incentives for distributors to participate in the program.

The sales under the distributor program represented a new distribution channel for the company. Therefore, Sunbeam was unable to set an appropriate level of reserves for returns.\(^{458}\)

\(^{456}\) Staff Accounting Bulletin No. 101.


Restatement of Revenues and Other Significant Developments

In 1998, Sunbeam restated its revenues for 1997 from $1,168,182 to $1,073,090. In an amended filing of their 10K to the SEC, management wrote: “Upon examination, it was determined certain revenue was improperly recognized (principally ‘bill and hold’ and guaranteed sales transactions).” The company had reversed all “bill and hold” sales, which amounted to $29 million in 1997, and about $36 million in guaranteed or consignment sales, whose liberal return policies made the recognition of their revenue improper.

Following several quarters of disappointing sales and earnings results, Sunbeam’s CEO Roger Schipke tendered his resignation in April 1996. The company named as Schipke’s successor Albert J. Dunlap, chief of Scott Paper Co. and a turnaround specialist who was nicknamed “Chainsaw Al” because of the cost-cutting measures he typically employed. Despite Dunlap’s efforts to achieve a successful turnaround, Sunbeam disappointed investors with lower-than-expected results in the fourth quarter of 1997 and the first quarter of 1998. CEO and Chairman Dunlap was fired in June 1998.

It was later uncovered that Sunbeam’s results in 1996, 1997, and 1998 were fraudulent in several aspects. In October 1998, Sunbeam announced that the audit committee of its Board of Directors had determined that the company would need to restate its prior financial statements, as follows: to reduce the 1996 net loss by $20 million (9 percent of reported losses); to reduce 1997 net income by $71 million (65 percent of reported earnings); and to increase 1998 earnings by $10 million (21 percent of reported losses).

Sunbeam’s auditor, Arthur Andersen, came under fire for having issued an unqualified opinion on the company’s financial statements for 1996 and 1997. In January 1999, a class action lawsuit alleging violation of the federal securities laws was filed in the U.S. District Court for the Southern District of Florida against Sunbeam,

459 Amended 1997 10K filing to SEC.


Arthur Andersen, and Sunbeam executives. The suit reached a settlement in August 2002. As part of the settlement, Andersen agreed to pay $110 million.\footnote{Nicole Harris, “Andersen to Pay $110 Million to Settle Sunbeam Accounting-Fraud Lawsuit,” \textit{Wall Street Journal}, May 2, 2001, B11.}

Phillip Harlow, the engagement Partner-in-Charge of the Sunbeam audit from 1993 to the summer of 1998, also found himself under fire for his work on the audits. The SEC barred Harlow from serving as a public accountant for three years after it found that Harlow failed to exercise professional care in performing the audits of Sunbeam’s financial statements.\footnote{Cassell Bryan-Low, “Deals & Deal Makers,” \textit{Wall Street Journal}, January 28, 2003, C5.}

1996 and 1997 Audits

Through the course of the 1996 audit, Phillip Harlow allegedly became aware of several accounting practices that failed to comply with GAAP. In particular, he allegedly knew about Sunbeam’s improper restructuring costs, excessive litigation reserves, and an excessive “cooperative advertising” figure.

Harlow also allegedly discovered several items that were not compliant with GAAP during the course of the 1997 audit. These items related to revenue, the restructuring reserves, and inventory, in particular. In several cases, Harlow made proposed adjustments that management refused to make. In response to management’s refusal, Harlow acquiesced, however. By the end of 1997, it appears that Harlow knew that approximately 16 percent of Sunbeam’s reported 1997 income came from items that he found to be noncompliant with GAAP.\footnote{“Complaint for Civil Injunction and Civil Penalties,” SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 7–8.} In fact, at least $62 million of Sunbeam’s reported $189 million of income before tax failed to comply with GAAP.\footnote{SEC Accounting and Auditing Enforcement Release No. 1393, May 15, 2001.}

Improper Restructuring Costs

During the 1996 audit, Harlow allegedly identified $18.7 million in items within Sunbeam’s restructuring reserve that were improperly classified as restructuring costs because they benefited Sunbeam’s future operations. Harlow proposed that the company reverse the improper accounting entries, but management rejected his proposed
adjustments for these entries. Harlow relented after deciding that the items were immaterial for the 1996 financials.  

**Excessive Litigation Reserves**

Sunbeam also failed to comply with GAAP on a $12 million reserve that was recorded for a lawsuit that alleged Sunbeam’s potential obligation to cover a portion of the cleanup costs for a hazardous waste site. Management did not take appropriate steps to determine whether the amount reflected a probable and reasonable estimate of the loss. Had they done so, the reserve would not have passed either of the criteria. Harlow relied on statements from Sunbeam’s General Counsel and did not take additional steps to determine that the litigation reserve level was compliant with GAAP.  

**Excessive “Cooperative Advertising” Reserve**

Sunbeam also recognized an excessive figure for a “cooperative advertising” reserve established to fund a portion of its retailers’ costs of running local promotions. At an amount of $21.8 million, the reserve was approximately 25 percent higher than the prior year’s accrual amount, without a proportional increase in sales. Harlow accepted management’s representations that the accrual was an appropriate figure and did not ask for additional documentation to test the amount.  

**Bill and Hold Sales**

The SEC found that Harlow “knew or recklessly disregarded facts indicating that the fourth-quarter bill and hold transactions did not satisfy required revenue recognition criteria.” Among other things, Sunbeam’s revenues earned through bill and hold sales should not have been recognized because these sales were not requested by Sunbeam’s customers and served no business purpose other than to accelerate revenue recognition by Sunbeam.


468 Ibid., 7–8.

Sunbeam offered their customers in the sales the right to return the unsold product. Further, several of Sunbeam’s bill and hold sales were also characterized by Sunbeam offering its customers financial incentives, such as discounted pricing, to write purchase orders before they actually needed the goods.\footnote{SEC Accounting and Auditing Enforcement Release No. 1393, May 15, 2001.}

**Sale of Inventory**

Sunbeam’s fourth-quarter revenue included $11 million from a sale of its spare parts inventory to EPI Printers, which, prior to this transaction, had satisfied spare parts and warranty requests for Sunbeam’s customers on an as-needed basis. As part of the transaction, Sunbeam agreed to pay certain fees and guaranteed a 5 percent profit for EPI Printers on the resale of the inventory. The contract with EPI Printers also stipulated that it would terminate in January 1998 if the parties did not agree on the value of the inventory underlying the contract.

Harlow allegedly knew that revenue recognition on this transaction did not comply with GAAP because of the profit guarantee and the indeterminate value of the contract. Thus, he proposed an adjustment to reverse the accounting entries that reflected the revenue and income recognition for this transaction. Yet, Harlow acquiesced to management’s refusal to reverse the sale.\footnote{“Complaint for Civil Injunction and Civil Penalties,” SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 33–34.}

**Improper Use of Reserves**

In the fourth quarter of 1997, Sunbeam improperly used excessive restructuring reserves to reduce current expenses. In fact, this use of reserves increased fourth-quarter income by almost 8 percent. Harlow proposed an adjustment to reverse this improper reduction. However, when management refused to make the adjustment, Harlow complied.\footnote{Ibid., 35–37.}

**Times of Trouble**

After the first quarter of 1997, Dunlap heralded the success of the company’s turnaround efforts:

> The impressive growth in both revenues and earnings is proof that the revitalization of Sunbeam is working.

> In fact, the sales growth in the first quarter is the highest level achieved without acquisitions since Sunbeam
The substantially higher earnings in the quarter from ongoing operations were due to increased sales coupled with the successful implementation of our restructuring efforts. Yet, by the fourth quarter of 1997, Sunbeam’s results had fallen below expectations. Its first quarter results in 1998 earned a worse-than-expected loss of $44.6 million. CEO and Chairman Dunlap was fired in June 1998. In October 1998, Sunbeam announced that the audit committee of its Board of Directors had determined that the company would need to restate its prior financial statements, as follows: to reduce the 1996 net loss by $20 million (9 percent of reported losses); to reduce 1997 net income by $71 million (65 percent of reported earnings); and to increase 1998 earnings by $10 million (21 percent of reported losses).

Sunbeam filed for Chapter 11 bankruptcy protection in February 2001. In May 2001, the SEC brought charges of fraud against several former Sunbeam officials. At the end of 2002, the company emerged from Chapter 11 and changed its name to American Household. In early 2005, it was acquired by Jarden to be part of its consumer solutions division.

Comprehensive List of Case Questions

1. Please consider the alleged accounting improprieties related to increased expenses from the 1996 audit. If you were auditing Sunbeam, what type of evidence would you like to review to determine whether Sunbeam had recorded the litigation reserve amount and the cooperative advertising amount in accordance with GAAP?

2. For the excessive litigation reserves and excessive “cooperative advertising” amount, please identify the journal entry that is likely to have been proposed by Andersen to correct each of these accounting improprieties. Why would Sunbeam be interested in recording journal entries that essentially reduced their income before tax in 1996?

3. As discussed in the case, during both the 1996 and the 1997 audit, Phillip Harlow allegedly discovered a number of different accounting entries made by Sunbeam that were not compliant with GAAP. Please speculate about

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how Mr. Harlow may have explained his decision not to require Sunbeam to correct these alleged misstatements in the audit working papers.

4. Consult Section 204 of SOX and Paragraphs 55–59 of PCAOB Auditing Standard No. 2. In the post-Sarbanes audit environment, which of the issues that arose in 1996 and 1997 would have to be reported to the audit committee at Sunbeam? Do you believe that communication to the audit committee would have made a difference in Mr. Harlow’s decision not to record the adjusting journal entries? Why or why not?

5. Based on your understanding of fraud risk assessment, what are the three conditions that are likely to be present when a fraud occurs? Based on your understanding of the Sunbeam audit, which of these three conditions appears to be most prevalent, and why?

6. Consult Paragraph #39 of PCAOB Auditing Standard No. 2. Based on your understanding of inherent risk assessment and case information, please identify three specific factors about Sunbeam that might cause you to elevate inherent risk.

7. Please consult Q39 and Q43 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of the inherent risks identified at Sunbeam (in Question #2) would influence the nature, timing, and extent of your audit work at Sunbeam.

8. Consult Paragraphs #71–72 of the Internal Control Standard. First, explain what is meant by “classes of transactions.” Next, based on the case information, list the different classes of transactions for the revenue account. Finally, do you believe that the different classes of transactions have differing levels of inherent risk? Why or why not?

9. Paragraph #25 of PCAOB Auditing Standard No. 2 requires management to design and implement controls to prevent, deter, and detect fraud. In addition, the standard requires the auditor to evaluate such controls (Paragraph #24). For one of Sunbeam’s classes of revenue transactions (choose one), please brainstorm about how a revenue recognition fraud might occur. Next, can you think of an internal control procedure that would prevent, detect, or deter such a fraudulent scheme?

10. Please explain what is meant by a restructuring reserve. As an auditor, what type of evidence would you want to examine to determine whether a company was inappropriately accounting for its restructuring reserve?

11. Refer to Paragraph #72 of PCAOB Auditing Standard No. 2. As an auditor, would you consider the different components of the restructuring reserve as having a “differing level” of inherent risk? Why or why not?
12. Please refer to Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Identify one relevant financial statement assertion related to the restructuring reserve account. Why is it relevant?

13. This case describes a situation where a company overstated its recorded expenses in 1996 (as compared to understating recorded expenses). Why would a company choose to overstate its expenses and understate its net income?

14. Please consider Paragraphs #61–65 of PCAOB Auditing Standard No. 2. Do you believe that revenue derived from bill and hold sales, and revenue derived from sales to customers receiving special discounts should be evaluated differently when considering the design and operating effectiveness of the internal control system? Why or why not?

15. As an auditor, what type of evidence would you want to examine to determine whether Sunbeam was inappropriately recording revenue from special discount sales?

16. Please consider Paragraph #96 of PCAOB Auditing Standard No. 2. Do you believe that the control activity described would be helpful to detect the fraudulent sales recorded by Sunbeam to customers receiving special discounts? Why?

17. Consider Paragraphs #55–59 of PCAOB Auditing Standard No. 2. Identify one action that the Audit Committee of Sunbeam could have taken to help insure that a revenue recognition fraud would not have occurred.
Case A.5

Qwest

When Joseph Nacchio became Qwest’s CEO in January 1997 its existing strategy to construct a state-of-the-art fiber-optic network across major cities in the United States, began to shift toward communications services as well. By the time it released earnings in 1998, Nacchio proclaimed Qwest’s successful transition from a network construction company to a communications services provider. “We successfully transitioned Qwest … into a leading Internet protocol-based multimedia company focused on the convergence of data, video, and voice services.”

During 1999 and 2000, Qwest consistently met its aggressive revenue targets and became a darling to its investors. Yet, it was later uncovered that Qwest had fraudulently recognized $3.8 billion in revenues and fraudulently excluded $231 million in expenses. When the company announced its intention to restate revenues, its stock price plunged to a low of $1.11 per share in August 2002, from a high of $55 per share in July 2000. During this period, its market capitalization declined by 98 percent, from a high of $91 billion to a low of $1.9 billion.

Strategic Direction

In the mid-1990s, Qwest Communications International embarked on building a fiber-optic network across major cities within the United States. The network would consist of a series of cables that contained strands of pure glass that could transmit data by using light and the appropriate equipment. Qwest’s initial strategy was to build the network of fiber cable and sell it in the form of an Indefeasible Right of Use (IRU), an irrevocable right to use a specific amount of fiber for a specified time period.

However, when Joseph Nacchio became Qwest’s CEO in January 1997, the strategy of the company shifted toward communications services. Nacchio envisioned that Qwest had the potential of becoming a major telecommunications company that offered Internet and multimedia services over its fiber-optic network, in addition

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477 SEC v. Qwest, 1–2.
to offering traditional voice communications services as well.478

**Qwest’s Construction Services Business**

A fiber-optic network consisted of a series of cables that contained strands of pure glass and allowed the transmission of data between any two connected points by using beams of light. While each cable of the fiber optic network typically contained at least 96 strands of fiber, Qwest intended to use 48 of the fiber strands for its own use and to sell the remaining strands to help finance the cost of construction of the network.479 Total revenue from its construction services business was approximately $224.5 million, $688.4 million, and $581.4 million in 1999, 1998, and 1997, respectively.480

**Competition**

As of 1999, Qwest faced competition from three other principal facilities-based long-distance fiber-optic networks: AT&T, Sprint, and MCI WorldCom. In its 1999 annual filing with the SEC, Qwest warned investors that others—including Global Crossing, GTE, Broadwing, and Williams Communications—were building or planning networks that could employ advanced technology similar to Qwest’s network. Yet, Qwest assured investors that it was at a significant advantage because its network would be completed in mid-1999, at least a year ahead of the planned completion of other networks, and that it could extend and expand the capacity on its network using the additional fibers that it had retained.481

**Qwest’s Communications Services Business**

As part of its communications services business, Qwest provided traditional voice communications services, as well as Internet and multimedia services to business customers, governmental agencies, and consumers in domestic and international markets. Qwest also provided wholesale services to other communications providers, including Internet service providers (ISPs) and other data service companies. Total revenue from its communications services business

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479 1997 10-K, 10.

480 1999 10-K, 12.

was approximately $3,703.1 million, $1,554.3 million, and $115.3 million in 1999, 1998, and 1997, respectively.\textsuperscript{482}

**Regulation**

The impact of regulatory change was significant in the highly regulated telecommunications industry. The Telecommunications Act of 1996 increased competition in the long distance market by allowing the entry of local exchange carriers and others. Indeed, Qwest warned investors in its 1999 annual filing with the SEC that its costs of providing long distance services could be affected by changes in the rules controlling the form and amount of “access charges” long distance carriers had to pay local exchange carriers to use the local networks they needed to provide the local portion of long distance calls.\textsuperscript{483}

**Competition**

Qwest’s primary competitors in its communications services business included AT&T, Sprint, and MCI WorldCom, all of whom had extensive experience in the traditional long distance market. In addition, the industry faced continuing consolidation, such as the merger of MCI and WorldCom.

In the markets for Internet and multimedia services, Qwest competed with a wide range of companies that provided web hosting, Internet access, and other Internet Protocol (IP) products and services. Significant competitors included GTE, UUNET (a subsidiary of MCI WorldCom), Digex, AboveNet, Intel, and Exodus.\textsuperscript{484}

**Qwest’s Mergers and Acquisitions**

To facilitate its growth in its communications services revenue, Quest unveiled an aggressive acquisition strategy in the late 1990s. From October 1997 to December 1998, it acquired, SuperNet, Inc., a regional ISP in the Rocky Mountain region; in March 1998, it acquired Phoenix Network, Inc., a reseller of long distance services; in April 1998, it acquired EUnet International Limited, a leading European ISP; in June 1998, it purchased LCI International, Inc., a provider of long distance telephone services; and in December 1998, it acquired Icon CMT Corp., a leading Internet solutions provider.\textsuperscript{485} In many of these acquisitions, Qwest used its own company stock as the tender that

\textsuperscript{482} 1999 10-K, 10.

\textsuperscript{483} 1999 10-K, 14–17.

\textsuperscript{484} 1999 10-K, 13.

\textsuperscript{485} 1998 10-K, 5.
was needed to acquire the companies.

Qwest’s string of acquisitions culminated during 1999 when it entered into a merger agreement with telecommunications company US West on July 18, 1999. The merger agreement required Qwest to issue $69 worth of its common stock for each share of US West stock, and it gave US West the option to terminate the agreement if the average price of Qwest stock was below $22 per share or the closing price was below $22 per share for 20 consecutive trading days. Less than a month after the merger announcement, Qwest’s stock price had dropped from $34 to $26 per share. So, to prevent any further drops in its stock price, executives and managers were pressured by CEO Nacchio to meet earnings targets to ensure that price per share did not fall below the level specified in the agreement. Although Qwest’s stock price had dropped from $34 to $26 per share less than a month after the merger announcement, Qwest stock was trading above $50 per share by June 2000; Qwest was, therefore, able to acquire US West by using Qwest’s common stock.

Following the merger, Qwest’s senior management set ambitious targets for revenue and earnings of the merged company. These targets were especially ambitious in the face of difficult industry conditions. For example, in Qwest’s earnings release for the second quarter 2000, on July 19, 2000, Nacchio said that Qwest would “generate compound annual growth rates of 15–17 percent revenue … through 2005.” At a January 2001 all-employee meeting, Nacchio stated his philosophy on the importance of meeting targeted revenues:

[T]he most important thing we do is meet our numbers. It’s more important than any individual product, it’s more important than any individual philosophy, it’s more important than any individual cultural change we’re making. We stop everything else when we don’t make the numbers.

Challenges

By 1999, Qwest encountered several obstacles that challenged its ability to meet its aggressive revenue and earnings targets. It faced increased competition from long distance providers, steep declines in the demand for Internet services, an overcapacity in the market resulting from the formation of other major fiber-optic networks, and a decline in the price at which Qwest could sell its excess fiber-optic capacity due to the increase in capacity.\(^\text{487}\)

\(^{486}\) SEC v. Qwest, 6–7.

\(^{487}\) SEC v. Qwest, 7–8.
Despite these significant industry challenges, Qwest’s senior management publicly claimed that the company would continue its pattern of dramatic revenue increases because of a “flight to quality” that customers would enjoy when they left competitors to use Qwest’s services. Within the company, Qwest senior management exerted extraordinary pressure on their subordinate managers and employees to meet or exceed the publicly announced revenue targets. In addition, they only paid bonuses to management and employees for periods when they achieved targeted revenue.488

Sale of Network Assets Initially Held for Use and Capital Equipment

To help meet revenue targets, senior management also began to sell portions of its own domestic fiber-optic network. Originally, this network was to be held for Qwest’s own use and had previously been identified as the “principal asset” of Qwest. Specifically, Qwest sold indefeasible rights of use (IRUs), for specific fiber capacity that it had constructed and used in its own communications services business. In addition, Qwest sold pieces of the network it had acquired from other third parties. And finally, Qwest also sold used capital equipment to generate additional revenue.

Unlike recurring service revenue from its communication services business that produced a predictable amount of revenue in future quarters, revenue from IRUs and other equipment sales had no guarantee of recurrence in future quarters. In fact, both IRUs and equipment sales were referred to internally as “one hit wonders.”489

In its earnings releases during 1999 through 2001, Qwest executives would often fail to disclose the impact of nonrecurring revenues. (See Table 3.8.1. in Section 3, on pages 101 and 102.) In its earnings releases and the Management’s Discussion and Analysis portion of its SEC filings, Qwest improperly characterized nonrecurring revenue as service revenue, often within the “data and Internet service revenues” line item on the financial statements. Qwest’s nonrecurring revenue was included primarily in the wholesale services segment, and to a lesser extent, the retail services segment.490

IRU Swap Transactions

488 SEC v. Qwest, 8.

489 SEC v. Qwest, 9–10.

Included within the $3.8 billion of revenues that were fraudulently recognized by Qwest were IRU swap transactions. In such transactions, Qwest would sell IRUs to customers in exchange for purchasing fiber or capacity in similar dollar amounts from those same customers. Under GAAP, no revenue should be recognized in this type of swap transaction unless Qwest had a *legitimate business need* to purchase the IRU capacity simultaneously from the other telecommunications company. Unfortunately, based on the available evidence, it appears that many of Qwest’s IRU swap transactions failed to meet the requirement to recognize revenue. In addition, in some cases, Qwest’s executives backdated documents for IRU swap transactions to enable earlier revenue recognition.

**Business Need for Assets Purchased in IRU Swap Transactions**

Beginning in 1999, Qwest found it increasingly difficult to sell IRUs to customers unless it purchased fiber or capacity in similar dollar amounts from those same customers in transactions referred to as “swaps.” For example, in the third quarter 2001, Qwest agreed to purchase $67.2 million of capacity in Pan America from Global Crossing in a swap transaction because Global Crossing could deliver the capacity by the close of the third quarter, a necessary element for booking revenue on Qwest’s simultaneous sale to Global Crossing. Yet, many of the assets Qwest purchased in swap transactions seemingly did not have a legitimate business purpose, besides their role in the completion of a swap transaction.

**Qwest’s Failure to Use Assets Purchased in Swap Transactions**

In most cases, Qwest did not use the assets that it purchased. For example, on September 29, 2000, Qwest purchased from Global Crossing $20.8 million in capacity across the Pacific Ocean as part of a swap transaction. Qwest never activated the capacity and, six months later, returned the $20.8 million in capacity as a credit toward the purchase of different capacity from Global Crossing. In fact, members of Qwest’s senior management directed and established quotas for the IRU sales teams to resell capacity that Qwest “[took] on as a result of trades with other carriers that we do not intend to use.”

**Qwest’s Purchase of Assets That Duplicated Other Assets It Owned**

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491 SEC v. Qwest, 31.

492 SEC v. Qwest, 32.

493 SEC v. Qwest, 30.
Many of the routes Qwest purchased in IRU swaps duplicated network assets that Qwest already possessed. For example, Qwest purchased similar East Asia capacity during 2001 in four swap transactions with Cable & Wireless, Global Crossing, Flag Telecom, and TyCom Networks. Because the routes were redundant, Qwest did not have a business use for at least three of the four routes. In another example, Qwest engaged in a swap with Enron on December 21, 1999, whereby it bought fiber between Denver and Dallas for $39.2 million. However, Qwest had already built and completed a route between those cities that had excess capacity and the ability to be expanded.\(^{494}\)

**Interaction of IRU Sales Staff with Network Planning Department**

Although Qwest’s network planning department was responsible for determining what capacity was needed to expand or develop Qwest’s fiber-optic network, Qwest’s IRU salespeople did not generally consult with the network planning department before purchasing assets in a swap.\(^ {495}\) In those few instances when Qwest’s network planning department was consulted, it recommended against the purchase of capacity because Qwest had little or no need for the IRU.\(^ {496}\) For example, prior to the purchase of a large amount of fiber from Enron in a third quarter 2001 swap, in which Qwest recognized $85.5 million in revenue on the sale, Qwest’s network planning group made it clear that the Qwest network had no need for the majority of Enron’s fiber route and other assets.\(^ {497}\)

**Study on Use of International Capacity Purchased in IRU Swaps**

In late 2001 through early 2002, Qwest conducted a study to determine how to use the international capacity it had purchased in IRU swaps. The study concluded that Qwest could possibly use or resell only one-third of the capacity it had purchased in the swaps. The remaining two-thirds of the capacity purchased was not needed by Qwest, could not be resold, and was, therefore, worthless.\(^ {498}\)

**Accounting for Swap Transactions**

In accounting for swaps, Qwest recognized large amounts of revenue immediately, which was an aggressive method

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\(^{494}\) SEC v. Qwest, 32–33.

\(^{495}\) SEC v. Qwest, 31.

\(^{496}\) SEC v. Qwest, 31.

\(^{497}\) SEC v. Qwest, 31.

\(^{498}\) SEC v. Qwest, 30.
relative to the rest of the telecommunications industry. Yet, Qwest capitalized its costs related to purchasing capacity from others as long-term assets that were amortized over the 20–25 year term of the IRU.499

During 2000 and 2001, the frequency, dollar amount, and number of swap transactions grew as Qwest tried to meet its aggressive revenue targets in the face of declining demand for fiber-optic assets. Internally, some Qwest managers and employees referred to these transactions using the acronym of “SLUTS,” which stood for simultaneous, legally unrelated transactions. In fact, most of Qwest’s swaps were completed as directed by members of senior management in the waning days and hours of each quarter in desperate attempts to achieve previously stated revenue targets.500

Pressure from senior management even motivated employees to backdate contracts to falsely demonstrate that a contract was “completed” by the end of the quarter. For example, the company recorded revenue of $69.8 million in the first quarter of 2001 on a swap transaction with Cable & Wireless that had not closed until after the quarter (on April 12, 2001) by backdating the contract to March 30, 2001. In another example of backdating, in the third quarter of 2001, Qwest recognized $85.5 million of revenue on the sale of IRU capacity in a swap with Enron. The parties’ agreements, which are dated September 30, 2001, were not executed until October 1, 2001, after the close of the quarter.501

Premature Revenue Recognition

Included within the $3.8 billion of revenues that were fraudulently recognized by Qwest were prematurely recognized revenues from sales of IRUs for its network. Qwest treated IRU sales as sales-type leases, which allow a seller to treat a lease transaction as a sale of an asset with complete, upfront revenue recognition. According to GAAP, this type of upfront revenue recognition required: (1) completion of the earnings process; (2) that the assets sold remain fixed and unchanged; (3) full transfer of ownership, with no continuing involvement by the seller; and (4) an assessment of fair market value of the revenue components. In addition, as part of the completion of the earnings process, the assets being sold had to be explicitly and specifically identified.

499 SEC v. Qwest, 24.
500 SEC v. Qwest, 24.
Portability

Qwest generally allowed customers of IRUs the ability to port, or exchange, IRUs purchased for other IRUs. By mid-2001, Qwest had ported at least 10 percent of assets sold as IRUs. Portability was not uncommon in the telecommunications industry, because companies needed the flexibility to change their network as demand changed.\(^{502}\)

However, because the practice of porting jeopardized Qwest’s ability to recognize revenue on IRUs upfront, Qwest salespeople would often grant its customers the right to port through secret side agreements or verbal assurances. For example, in the fourth quarter 2000, Qwest sold to Cable & Wireless $109 million of capacity in the United States (and recognized $108 million in upfront revenue) by providing a secret side agreement, which guaranteed that Cable & Wireless could exchange the specific capacity it purchased at a late date.\(^{503}\)

As another example, in the first quarter of 2001, Qwest sold IRU capacity to Global Crossing and recognized $102 million of upfront revenue, after it gave secret verbal assurances to Global Crossing that Qwest would agree to exchange the capacity when the IRU capacity that Global Crossing actually wanted became available.\(^{504}\)

Ownership Transfer

Qwest also had a significant continuing involvement with all IRUs sold in the form of ongoing administrative, operating, and maintenance activities. While Qwest’s IRU sales agreements generally provided for title transfer at the end of the lease term, conditions also existed that would require that the title remained with Qwest, in reality. In addition, there was significant uncertainty about whether the title would ever transfer in certain other situations.\(^{505}\)

Interestingly, there was no statutory title transfer system for IRUs that is comparable to what exists for real property. In addition, some of Qwest’s “right of way” agreements on the underlying IRUs actually expired prior to the end of the IRU terms. Further, some of the underlying IRU agreements (concerning IRUs that Qwest purchased from a third party, and then resold) did not allow Qwest to sublease its “rights of way” or did not provide title to

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\(^{502}\) SEC v. Qwest, 20.

\(^{503}\) SEC v. Qwest, 26–27.

\(^{504}\) SEC v. Qwest, 26–27.

\(^{505}\) SEC v. Qwest, 22–23.
Qwest. Therefore, Qwest could not legally provide those rights to a third party.\textsuperscript{506}

In some IRU contracts, Qwest specifically stated that the purchaser did not receive any ownership interest in the fiber. Similarly, in many contracts, Qwest prohibited the purchaser from assigning, selling, or transferring the fiber-optic capacity, without Qwest’s prior written consent. For example, on March 31, 2000, Qwest entered into a $9.6 million IRU transaction with Cable & Wireless in which Qwest included a clause preventing assignment, sale, or transfer without Qwest’s consent.\textsuperscript{507}

**Other Characteristics That Failed to Comply with GAAP**

Qwest’s upfront revenue recognition of IRUs was also premature because Qwest routinely neglected to specify the assets it was selling. For example, in the first quarter ended March 31, 2001, Qwest sold $105 million of fiber-optic capacity to Global Crossing and recognized approximately $102 million in revenue on the sale. This was done despite the fact that the majority of the capacity was not specified in the contract by the end of the quarter. Rather, the contract exhibit intended to list the assets sold simply stated—“to be identified.” Further, Global Crossing and Qwest did not identify the geographic termination points of some of the capacity purchased by Qwest until June 2001, three months after Qwest recognized the revenue on the sale transaction.\textsuperscript{508}

In addition, to circumvent problems on its network or to optimize the network’s efficiency, Qwest often moved IRUs previously sold, without customer consent, to different wavelengths and different routes as required. This process was known as *grooming*. During the third and fourth quarters of 2001, Qwest senior management knew of numerous IRUs that had been rerouted on different fibers. Qwest personnel informed senior management that the IRUs could not be restored to their original routes and advised senior management to reverse the revenue recognized from the IRU sales. Qwest senior management, however, rejected the employees’ recommendations. From the fourth quarter of 2001 through early 2002, Qwest continued to reroute IRU fibers as necessary.\textsuperscript{509}

**Dex’s Changes to Publication Dates and Lives of Directories**

\textsuperscript{506} SEC v. Qwest, 22.

\textsuperscript{507} SEC v. Qwest, 22.

\textsuperscript{508} SEC v. Qwest, 28.

\textsuperscript{509} SEC v. Qwest, 21.
As part of its scheme to mislead the marketplace, Qwest executives often made false and misleading disclosures concerning revenues from its directory services unit, Qwest Dex Inc. (Dex). Qwest manipulated revenue from Dex for 2000 and 2001 by secretly altering directory publication dates and the lives of directories.

Dex published telephone directories year-round in approximately 300 markets in 14 states. It earned revenue by selling advertising space in its directories. Each of its directories typically had a life of 12 months, and Qwest traditionally recognized directory revenue over the life of the directory. However, in late 1999, Dex adopted a “point of publication” method of accounting and began to recognize all advertising revenue for a directory as soon as Dex began deliveries of that directory to the public.

In August 2000, Dex executives informed Qwest senior management that Dex would be unable to achieve the aggressive 2000 earnings’ targets that management had set for it. As one option for making up for the shortfall, Dex suggested that it could publish Dex’s Colorado Springs directory in December 2000 rather than January 2001 as scheduled, thereby allowing Qwest to recognize revenue from the directory in 2000 rather than 2001. One Dex executive expressed opposition, citing his concern that such a schedule change would severely reduce 2001 revenue and earnings. He also expressed his view that Qwest probably would be required to disclose the change in the regulatory filings with the SEC. Despite this executive’s opposition, Qwest senior management instructed Dex to move forward with the proposed change.

By recognizing revenue from the Colorado Springs directory in 2000, Qwest generated $28 million in additional revenue and $18 million in additional earnings before interest and tax, depreciation, and amortization (EBITDA) for the year. The additional revenue generated in 2000 accounted for about 30 percent of Dex’s 2000 year-over-year revenue increase. It further allowed Dex to show 6.6 percent year-over-year revenue growth versus 4.6 percent if the schedule change had not been made.

In Qwest’s 2000 Form 10-K, Qwest informed investors that Dex’s revenue for 2000 increased by almost $100 million. It wrote that the increase was due in part to “an increase in the number of directories published.” At the same time, it failed to inform investors that Dex generated nearly one-third of that amount by publishing the Colorado Springs directory twice in 2000. It also did not inform investors that the schedule change would produce a corresponding decline in Dex revenue for the first quarter of 2001.

For 2001, Qwest senior management established revenue and EBITDA targets for Dex that were higher than what Dex management believed was possible to achieve. In fact, the EBITDA target was $80–100 million greater
than the amount Dex management believed was achievable. Dex management complained to Qwest’s senior management about the unrealistic targets. Yet, Qwest’s senior management not only refused to change the targets, but it also did not allow Dex a reduction in the targets to compensate for the revenue from the Colorado Springs directory that was recognized in 2000.

In March 2001, Dex management met with some of Qwest’s senior management to discuss “gap-closing” ideas for the first two quarters of 2001 in an attempt to achieve its 2001 financial targets. One idea was to advance the publication dates of several directories, thus, allowing Dex to recognize revenue in earlier quarters; another idea was to lengthen the lives of other directories from 12 to 13 months, thereby allowing Dex to bill each advertiser for one additional month of advertising fees in 2001. Senior managers at Qwest instructed the Dex managers to implement the changes. Similar changes were approved by senior management at Qwest and implemented by Dex to allow it to meet its third and fourth quarter financial targets.

During 2001, Dex advanced the publication dates or extended the lives of 34 directories. Those schedule changes produced $42 million in additional revenue and $41 million in additional EBITDA. Qwest’s Forms 10-Q for the first three quarters of 2001 stated that period-over-period improvements in Dex’s revenue were due in part to changes in the “mix” and/or the “lengths” of directories published. Like the 2000 Form 10-K, these reports did not include any information about the directory schedule changes or the reasons for those changes.

**Independent Auditor Arthur Andersen and the SEC**

The SEC brought charges against Mark Iwan, the Global Managing Partner at Arthur Andersen—the outside auditor for Qwest from 1999 to 2002—alleging that Iwan “unreasonably relied on management’s false representations that certain revenue recognition criteria for immediate revenue recognition on IRUs were met.” On account of these charges and others, the SEC ordered that Iwan was denied the privilege of appearing or practicing before the SEC as an accountant for a minimum of five years.

Specifically, the SEC found that Iwan learned that Qwest’s porting of capacity had risen to approximately 10 percent of the capacity sold by mid-2001. Although Iwan required Qwest to stop the practice of porting, he allegedly did not go back and ensure that the prior revenue recognition was in conformity with GAAP. Rather, Iwan exclusively relied on management’s representations that “Qwest had made no commitments to allow its customers to port capacity, that it was never Qwest’s intention to allow customers to port capacity, and that Qwest would not
honor any future request to port capacity.”

The SEC also found that Iwan relied on representations from Qwest’s management and legal counsel that title did actually transfer on IRUs. In fact, Iwan allegedly knew by early 2000 that Qwest senior tax personnel believed there were “significant uncertainties as to whether title transfer would occur” and, thus, Qwest would treat IRUs as operating leases for tax purposes. Surprisingly, Iwan failed to reconcile Qwest’s position on title transfer for IRUs for income tax reporting purposes with its different position for financial reporting purposes under GAAP.511

In 2001, Iwan required Qwest to obtain an outside legal opinion that Qwest had the ability to transfer title to the IRUs it sold over the past three years. Qwest provided to Iwan an abridged summary of the legal opinion that contained significant assumptions, qualifications, ambiguities, and limitations that were critical to evaluating whether Qwest met the ownership transfer requirements. Yet, Iwan continued to rely on the false representations of management and legal counsel in this regard.512

**Comprehensive List of Case Questions**

1. Based on your understanding of fraud risk assessment, what three conditions are likely to be present when a fraud occurs? Based on your understanding of the Qwest audit, which of these three conditions appears to be most prevalent and why?

2. Consult Paragraph #39 of PCAOB Auditing Standard No. 2. Based on your understanding of inherent risk assessment and the case information, please identify three specific factors about Qwest’s business model that might cause you to elevate inherent risk if you were conducting an audit of internal control over financial reporting at Qwest.

3. Consult Q39 and Q43 of the PCAOB Staff Questions & Answers (May 16, 2005). Please comment about how your understanding of the inherent risks identified at Qwest (in Question 2) would influence the nature, timing, and extent of your audit work at Qwest.

4. Please consult Paragraphs #71–72 of PCAOB Auditing Standard No. 2. Next, consider revenue earned in the

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construction services and the communication services businesses. Do you believe that any of the different types of revenue earned by Qwest would have a “different level” of inherent risk? Why or why not?

5. Please consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Define what is meant by control environment. Why does the “tone at the top” have a “pervasive” effect on the reliability of financial reporting at an audit client like Qwest? Based on the case information, do you believe that the proper “tone at the top” was established at Qwest? Why or why not?

6. Please consult Q38 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of Qwest’s control environment and other company level controls would help you implement a “top-down” approach to an internal control audit at Qwest.

7. Consider Paragraph #63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Please identify the most relevant financial statement assertion related to the nonrecurring revenue (i.e., “one-hit wonders”). Why is it the most relevant?

8. Please consider Paragraph #72 of PCAOB Auditing Standard No. 2. How would you classify the nonrecurring revenue (i.e., “one-hit wonders”)? Why?

9. Consult Q5 of the PCAOB Staff Questions & Answers (June 23, 2004) and your primary audit text. What is the auditor’s responsibility related to information disclosed by management at the time of an earnings release, if any? What is the auditor’s responsibility related to the information disclosed by management in the Management’s Discussion & Analysis section, if any? Do you agree with these responsibilities? Why or why not?

10. Please describe why the recognition of revenue for IRU swaps for fiber-optic assets that are not actually needed by Qwest is inappropriate under GAAP. As an auditor, what type of evidence would allow you to determine whether the recognition of revenue would be appropriate under GAAP?

11. Consider Paragraph #63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Please identify one relevant financial statement assertion related to the revenue account that is impacted by an IRU swap. Why is it relevant?

12. Please consult Paragraph #84 of PCAOB Auditing Standard No. 2. The paragraph states that “the auditor should clearly link individual controls with the significant accounts and assertions to which they relate.” For the assertion identified in Question #2, please identify a specific internal control activity that would help to prevent
or detect a misstatement related to the recognition of revenue for IRU swaps.

13. Has Qwest complied with the matching principle in accounting for their IRU swap transactions? Why or why not?

14. Consider Paragraph #25 of PCAOB Auditing Standard No. 2. Please discuss an internal control procedure that would help to prevent, detect, or deter the practice of “backdating” contracts to recognize revenue prematurely.

15. Please describe why the upfront revenue recognition practices for sales of IRUs by Qwest was not appropriate under GAAP. Please be specific.

16. Based on your understanding of audit evidence, did Arthur Andersen rely on sufficient and competent audit evidence in its audit of the Qwest’s upfront revenue recognition processes? Why or why not?

17. Please consider Paragraph #63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Identify one relevant financial statement assertion related to the revenue account used for IRU sales by Qwest. Why is this assertion relevant?

18. Consult Paragraph #84 of PCAOB Auditing Standard No. 2. For the assertion identified in Question #2, please identify a specific internal control activity/procedure that would help to prevent or detect a misstatement related to the practice of upfront revenue recognition of IRUs by Qwest.

19. Describe why the revenue recognition practices of Dex were not appropriate under GAAP. Please be specific.

20. Please consider Paragraph 63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Identify one relevant financial statement assertion related to revenue recognized at Dex. Why is this assertion relevant?

21. Consult Paragraph #84 of the Internal Control Standard. For the assertion identified in Question #2, identify a specific internal control activity that would help to prevent or detect a misstatement related to revenue recognition at Dex.

22. Consider the impact of the pressure exerted by Qwest’s senior management team to meet aggressive revenue and earnings targets. Please comment about why such a “tone at the top” would always have a pervasive effect on the reliability of financial reporting at an audit client like Qwest.

23. Please consult Paragraphs #49 and 114 of the PCAOB Auditing Standard No. 2. Next, comment about the impact that Qwest’s revenue disclosure practices would have on an auditor’s assessment of Qwest’ control environment.
Case A.6

The Baptist Foundation of Arizona

The Baptist Foundation of Arizona (BFA), was organized as an Arizona non-profit organization primarily to help provide financial support for various Southern Baptist causes. Under William Crotts’s leadership, the foundation engaged in a major strategic shift in its operations. BFA began to invest heavily in the Arizona real estate market, and also accelerated its efforts to sell investment agreements and mortgage-backed securities to church members.

Two of BFA’s most significant affiliates were ALO and New Church Ventures. It was later revealed that BFA had set up these affiliates to facilitate the “sale” of its real estate investments at prices significantly above fair market value. In so doing, BFA’s management perpetrated a fraudulent scheme that cost at least 13,000 investors more than $590 million. In fact, Arizona Attorney General Janet Napolitano called the BFA collapse the largest bankruptcy of a religious nonprofit in the history of the United States.513

Background

The Baptist Foundation of Arizona (BFA) was an Arizona religious nonprofit 501(c)(3) organization that was incorporated in 1948 to provide financial support for Southern Baptist causes. It was formed under the direction of the Arizona Southern Baptist Convention, which required BFA to be a profitable, self-sustaining independent entity (i.e., it could not accept money from any other source). In BFA’s early days, it focused its attention on funding church start-ups and providing aid for children and the elderly. In 1962, Pastor Glen Crotts became its first full-time president and was subsequently succeeded in 1984 by his son, William P. Crotts.

Under William Crotts’s leadership, the foundation engaged in a major strategic shift in its operations. BFA began to invest heavily in the Arizona real estate market, and also accelerated its efforts to sell investment agreements and mortgage-backed securities to church members. Soon after the decline in the Arizona real estate market in 1989, management decided to establish a number of related affiliates. These affiliates were controlled by individuals with close ties to BFA, such as former board members. In addition, BFA gained approval to operate a

trust department that would serve as a nonbank passive trustee for individual retirement accounts (IRAs). In order to do so, BFA had to meet certain regulatory requirements, which included minimum net worth guidelines.

Related Parties

Two of BFA’s most significant affiliates were ALO and New Church Ventures. A former BFA director incorporated both of these nonprofit entities. The entities had no employees of their own, and both organizations paid BFA substantial management fees to provide accounting, marketing, and administrative services. As a result, both ALO and New Church Ventures owed BFA significant amounts by the end of 1995. On an overall basis, BFA, New Church Ventures, and ALO had a combined negative net worth of $83.2 million at year-end 1995, $102.3 million at year-end 1996, and $124.0 million at year-end 1997.\(^\text{514}\)

New Church Ventures

Although the stated purpose of New Church Ventures was to finance new Southern Baptist churches in Arizona, its major investment activities were similar to those of BFA. That is, New Church Ventures raised most of its funds through the sale of investment agreements and mortgage-backed securities, and then invested most of those funds in real estate loans to ALO. Thus, the majority of New Church Ventures’s assets were receivables from ALO. New Church Ventures’s two main sources of funding were BFA’s marketing of its investment products to IRA investors and loans it received from BFA.\(^\text{515}\)

ALO

Contrary to its intended purpose to invest and develop real estate, one of ALO’s primary activities in the 1990s was to buy and hold BFA’s nonproducing and over-valued investments in real estate, so BFA could avoid recording losses (write-downs) on its real estate. In fact, ALO was the owner of many of the real estate investments that were utilized as collateral for IRA investor loans. However, BFA’s 1991 through 1997 financial statements did not include a set of summarized financial statements for ALO. ALO incurred operating losses each year since its inception in 1988. By the end of 1997, ALO’s total liabilities of $275.6 million were over two times its assets.

\(^{514}\) Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 3–4.

\(^{515}\) Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 8–9.
leaving a negative net worth of $138.9 million. In total, ALO owed New Church Ventures $173.6 million and BFA $70.3 million, respectively.\(^{516}\)

**BFA’S Religious Exemptions**

BFA operated in a manner similar to a bank in many respects. Its investment products were similar to those sold by financial institutions. Its trust department, which was fully authorized by the federal government to serve as a passive trustee of IRAs, was similar to a trust department at a bank. BFA also made real estate loans in a manner similar to a bank. Because of its bank-like operations and products, BFA faced several risk factors that affect banks and other savings institutions, such as interest-rate risk and liquidity risk.\(^{517}\)

Yet, because of its status as a religious organization, BFA’s product offerings were not subject to the same regulatory scrutiny as a bank’s products.\(^{518}\) That is, although BFA underwrote its own securities offerings and used its staff to sell the investment instruments (like a bank), it was able to claim a religious exemption from Arizona statutes that regulate such activities. BFA also claimed exemption from Arizona banking regulations on the basis that its investment products did not constitute deposits as defined by Arizona banking laws.\(^{519}\)

**Passive Trustee Operation**

BFA gained approval to operate a trust department that would serve as a nonbank passive trustee for IRAs. To operate a trust department, BFA had to comply with certain regulatory requirements, such as maintaining an appropriate minimum net worth. In addition to the minimum net worth requirement, treasury regulations also required BFA to conduct its affairs as a fiduciary, that is, it could not manage or direct the investment of IRA funds. In addition, BFA had to subject itself to an audit that would detect any failures to meet these regulatory requirements. In cases where the minimum net worth was not achieved, treasury regulations prohibited a trustee

\(^{516}\) Ibid., 8–9.

\(^{517}\) Ibid., 4–5.

\(^{518}\) Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 5.

\(^{519}\) Ibid., 4–5.
from accepting new IRA accounts and required the relinquishment of existing accounts.\textsuperscript{520}

**BFA’s Independent Auditors**

From 1984 to 1998, BFA engaged Arthur Andersen as its independent auditor. Arthur Andersen was also hired by BFA or BFA’s attorneys to perform other accounting and auditing, management consulting, and tax services. From 1984 to 1997, Arthur Andersen issued unqualified audit opinions on BFA’s combined financial statements.

From 1992 to 1998, Jay Steven Ozer was the Arthur Andersen engagement partner with the ultimate responsibility for the conduct of the BFA audits, including the review of all audit work performed, resolution of all accounting issues, evaluating the results of all audit procedures, and signing the final audit opinions. Ann McGrath was an auditor on the BFA engagement from 1988 to 1998. In 1991, she began her role as manager on the audit engagements. For audit years 1991 to 1998, McGrath had primary responsibility for all audit planning and field work, which included assessing areas of inherent and control risk, supervising the audit team, and reviewing all of the audit workpapers.\textsuperscript{521}

**Employees’ Concerns over ALO’s Deficit**

In April 1996, several of BFA’s accountants and one attorney were sufficiently concerned about ALO’s deficit situation and related financial viability issues to confront BFA’s senior management team. The response was perceived as inadequate by the employees. And, due to their concerns about the lack of response by the BFA senior management team, most of them resigned during 1996, citing their concerns in their letters of resignation. One of BFA’s accountants who showed concern was Karen Paetz.

**Karen Paetz’s Concerns**

Karen Paetz was familiar with the financial condition of ALO and the interrelationships among ALO, New Church Ventures, and BFA because one of her responsibilities had been to supervise the preparation of the financial statements of New Church Ventures and ALO. In 1994, at the request of BFA President Crotts, Paetz produced a detailed analysis of the fair market value of ALO’s assets as compared to the cost basis of its assets. Her analysis

\textsuperscript{520} Ibid., 15–20.

\textsuperscript{521} Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 3–4.
revealed a $70.1 million negative net worth. Paetz’s misgivings about ALO, New Churches Ventures, and BFA prompted her to resign as a BFA accountant in July 1996.

During the seven years Paetz was employed by BFA, she interacted frequently with the Arthur Andersen auditors during each year’s audit. In February 1997, during the field work for Arthur Andersen’s 1996 audit of BFA, Paetz decided to contact Arthur Andersen auditor Ann McGrath and set up a lunch meeting with McGrath in order to voice her concerns. At the meeting, Paetz expressed her concern about ALO’s deficit, which was in excess of $100 million and ALO’s monthly losses, which were approximately $2.5 million. In addition, Paetz noted that the money from BFA and New Church Ventures was being used to service ALO’s substantial debt to BFA. Paetz specifically advised McGrath to ask BFA, during the 1996 audit, for detailed financial statements for both ALO and New Church Ventures.

**Arthur Andersen’s Response to Concerns**

McGrath reported her meeting with Paetz to the engagement partner, Ozer. However, Arthur Andersen’s audit workpapers, and its analysis of fraud risk, did not make reference to the Paetz meeting in February 1997 because McGrath and Ozer considered the meeting to be a “nonevent.” Arthur Andersen did, however, expand its audit procedures for the 1996 audit and requested from BFA the detailed financial statements of ALO and New Church Ventures. However, BFA refused to make the detailed financial statements for both ALO and New Church Ventures available to McGrath and Ozer.

McGrath and Ozer decided not to insist that ALO’s financial statements be provided although the financial statements were necessary to properly assess ALO’s ability to repay its loans back to BFA and affiliate New Church Ventures. Fortunately, the financial statements of ALO were a matter of public record and part of a four-page annual disclosure statement that ALO had filed with the Arizona Corporation Commission on March 19, 1997, during Arthur Andersen’s field work for the 1996 audit. This four-page annual report showed a $116.5 million negative net

522 Ibid., 29–30.

523 Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 50–51.
worth as of year-end 1996, and a $22 million net loss for the year. New Church Ventures’ unaudited detailed financial statements were available for years 1995, 1996, and 1997. These financial statements revealed that substantially all of New Church Ventures’s notes receivable were from ALO.

**Disclosure of ALO and New Church Ventures in 1996 Financial Statements**

Footnote 3 to BFA’s combined financial statements as of December 31, 1996, included an unaudited condensed balance sheet for New Church Ventures (identified only as “a company associated with Southern Baptist causes”) as of year end 1996, which reported net assets of $2.5 million and total assets of $192.5 million. The footnote did not disclose ALO’s financial position or that approximately 81 percent of New Church Ventures’ assets were notes receivable from ALO. To the extent New Church Ventures receivables from ALO were uncollectible due to ALO’s negative net worth, New Church Ventures would not be able to meet its liabilities, which included liabilities to IRA holders by year-end 1996 that totaled $74.7 million.

**Year-End Transactions**

In December of each year, BFA engaged in significant year-end transactions with its related parties, ALO and New Church Ventures. These related party transactions primarily included real estate sales, gifts, pledges, and charitable contributions. Without these year-end transactions, BFA, on a stand-alone basis, would have been forced to report a significant decrease in net assets in each year, from 1991 to 1994. Yet, BFA did not disclose any information about these material-related party transactions in its financial statements for the years 1991 to 1994.

As an example, the significant real estate transactions that occurred in December 1995 with Harold Friend, Dwain Hoover, and subsidiaries of ALO enabled BFA to report an increase in net assets of $1.6 million for the year ended December 31, 1995, as opposed to a decrease in net assets that would have been reported. Importantly, for

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525 Ibid., 30–32.

526 Ibid., 31–32.

527 Ibid., 19–20.
BFA to recognize a gain on these transactions in accordance with GAAP, the down payment for the buyer’s initial investment could not be “funds that have been or will be loaned, refunded, or directly or indirectly provided to the buyer by the seller, or loans guaranteed or collateralized by the seller for the buyer.” However, in reality, the cash for the initial down payment on many of these real estate sales can be traced back to BFA via transactions with affiliates of ALO and New Church Ventures.

**Foundation Investments, Inc.’s Sale of Santa Fe Trails Ranch II, Inc. Stock**

Santa Fe Trails Ranch II, Inc. was a subsidiary of Select Trading Group, Inc., which was a subsidiary of ALO. The only significant asset owned by Santa Fe Trails Ranch II was 1,357 acres of undeveloped land in San Miguel County, New Mexico.

On December 26, 1995, 100 percent of the issued and outstanding common stock of Santa Fe Trails Ranch II was transferred from Select Trading Group to ALO. ALO then sold the stock to New Church Ventures in exchange for a $1.6 million reduction in ALO’s credit line that was already owed to New Church Ventures. On the same day, New Church Ventures sold the Santa Fe Trails Ranch II stock to Foundation Investments, Inc., a BFA subsidiary, in exchange for a $1.6 million reduction in the New Church Ventures’s credit line that was already owed to Foundation Investments. Also on the same day, Foundation Investments sold the Santa Fe Trails Ranch II stock to Harold Friend for $3.2 million, resulting in Foundation Investments recognizing a gain of $1.6 million in its financial statements.

The terms of the sale of the Santa Fe Trails Ranch II stock by Foundation Investments to Mr. Friend for $3.2 million was a 25 percent cash down payment ($800,000) with the balance of $2.4 million in a carry-back note receivable to Foundation Investments. To audit the transaction, Arthur Andersen’s senior auditor John Bauerle vouched the payment received from Friend via wire transfer back to the December 31, 1995, bank statement. However, he did not complete any additional work to determine the source of the cash down payment.

To assess the true nature and purpose of this series of transactions, Arthur Andersen reviewed a feasibility study and 1993 cash flow analysis for the proposed development of Cedar Hills. An independent appraisal was not obtained. Arthur Andersen prepared a net present value calculation using the 1993 cash flow analysis to support the $3.2 million value that Friend paid to Foundation Investments on December 26, 1995. Arthur Andersen accepted the

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528 Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 25.
$3.2 million value without questioning why that same property was valued at only $1.6 million when New Church Ventures sold it to Foundation Investments on the same day.

**TFCI’s Sale to Hoover**

In December 1995, The Foundation Companies, Inc., a for-profit BFA subsidiary, sold certain joint venture interests in real estate developments to Dwain Hoover and recognized a gain on the transaction of approximately $4.4 million. In this particular transaction, the cash down payment from Hoover to The Foundation Companies of approximately $2.9 million was funded by a loan to Hoover from FMC Holdings, Inc., a subsidiary of ALO. Importantly, FMC received its own funding from BFA and New Church Ventures.

The details of this transaction were documented in Arthur Andersen’s workpapers primarily through a memorandum prepared by Arthur Andersen senior auditor John Bauerle on April 13, 1996. According to his memo, Bauerle concluded that the transaction did meet the criteria for gain recognition pursuant to SFAS No. 66. However, Bauerle’s memorandum did not include any documentation to support how Arthur Andersen tested the source of the cash down payment to help assure that the down payment was not directly or indirectly provided by BFA.

In early 1996, Arthur Andersen was auditing The Foundation Companies and prepared their annual management representation letter to be signed by the Foundation Company’s Chief Financial Officer, Ron Estes. However, because of the previously described Hoover transaction, Estes refused to sign the management representation letter. CFO Estes had protested against the Hoover transaction and ultimately resigned in June 1996. Arthur Andersen’s audit workpapers related to the Foundation Companies 1995 audit did not address the absence of Estes’s signature on the final management representation letter or indicate if it made any inquiries of Estes as to why he refused to sign the letter.

**Related Parties Disclosure**

**1991–1994**

In addition to its affiliates, BFA’s related parties included its subsidiaries, BFA senior management and their

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immediate families, as well as any former or current members of the Board of Directors. Yet, except for information provided about New Church Ventures in its 1994 financial statements, the transactions and balances due from the following individuals and companies were not disclosed as related parties in the financial statements for the years 1991 through 1994:

- Dwain Hoover, BFA Board member;
- Harold Friend, former BFA Board member;
- Jalma Hunsinger, owner of ALO, former BFA Board member, and New Church Ventures Board member;
- ALO and its subsidiaries and affiliates; and
- New Church Ventures and its subsidiaries and affiliates.\(^\text{530}\)

1995

In the footnotes to BFA’s 1995 financial statements, rather than using their names, BFA described its related parties according to their titles or roles in the business. This practice made it far more difficult and time-consuming for users to identify the true identity of the related parties. For example, BFA disclosed its related parties as follows: “Director A [Dwain Hoover] and his companies”; “Benefactor A [Harold Friend] and his companies”; and “Benefactor B [Jalma Hunsinger] and his companies.” ALO was a Benefactor B company and New Church Ventures was “a company associated with Southern Baptist causes.”\(^\text{531}\)

Related Party Pseudonyms

- Director A = Dwain Hoover;
- Benefactor A = Harold Friend;
- Benefactor B = Jalma Hunsinger;
- ALO = a Benefactor B company; and
- New Church Ventures = a company associated with Southern Baptist causes.

BFA disclosed in Footnote 13 of its 1995 financial statements, entitled “Related Parties,” that “a substantial portion

\(^{530}\) Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, pp. 16–17.

\(^{531}\) Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 21.
of BFA’s transactions involve individuals or companies associated with Southern Baptist causes.” In Footnote 13, it described “some of the more significant transactions involving related parties,” including notes receivable from “Director A, Benefactor A, and Benefactor B or their companies” totaling $8,825,063, $2,400,000, and $53,797,827 (notes owed from ALO). Footnote 13 did not include an additional $37,400,000 in notes receivable owed to BFA from New Church Ventures, which was discussed in Footnote 3 entitled “Notes Receivable.”

The footnotes to the 1995 financial statements did not disclose the material nature of the total notes receivable owed to BFA from related parties ALO and New Church Ventures that accounted for 63 percent of BFA’s total notes receivable—or 30 percent of BFA’s total assets and more than ten times as much as BFA’s total net assets. This substantial concentration of credit given to ALO and New Church Ventures was also not disclosed in Footnote 2 in a subsection entitled: “Concentration of Credit Risk,” which stated: “Concentration of credit risk with respect to notes receivable are limited due to the fact that BFA requires notes receivable to be adequately collateralized.”

1996–1997

In connection with its 1996 audit of BFA, Arthur Andersen commented in a “Memorandum on Internal Control Structure” on BFA’s lack of review, analysis, and proper documentation of related party transactions.

Andersen also criticized the fact that the collateral on related party notes receivable was not adequately monitored. It noted that “certain of the notes receivable from individuals and companies affiliated with Southern Baptist causes had outstanding balances in excess of the current value of the underlying collateral.” Yet, Arthur Andersen did not require BFA to take a reserve or write-down on its notes receivable. Rather, in BFA’s 1996 financial statements, a footnote merely stated that “certain of the notes have outstanding balances that may be in

532 Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 21.
533 Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 20–22.
excess of underlying collateral.”

Again, for year-end 1997, Arthur Andersen assessed BFA’s internal controls and criticized BFA for lack of review, analysis, and proper documentation of related party transactions and for failing to adequately monitor collateral on related party notes receivable. The criticisms stated in the 1997 Internal Control Memorandum were practically identical to those made by Arthur Andersen in 1996. In fact, in the 1997 memorandum, Arthur Andersen noted that its 1996 audit recommendations regarding related parties had not been fully implemented and encouraged management to do so.

The 1997 memorandum repeated, almost verbatim, Arthur Andersen’s observation “that certain of the notes receivable from individuals and companies affiliated with Southern Baptist causes had outstanding balances, which appeared to be in excess of the current value of the underlying collateral.”

Like its opinion in 1996, Arthur Andersen issued an unqualified opinion on BFA’s 1997 financial statements, without requiring adequate disclosures regarding the concentration of credit risk with related parties and the nature of the relationships with ALO and New Church Ventures. The footnote disclosures regarding the amounts due from related parties also appeared to be inadequate and misleading to financial statement users.

**Comprehensive List of Case Questions**

1. Based on your understanding of inherent risk assessment, please identify three specific factors about BFA that might cause you to elevate inherent risk. Briefly provide your rationale for each factor that you identify.

2. Please comment on why the existence of related parties (such as ALO and New Church Ventures) present additional risks to an auditor. Do you believe that related party transactions deserve special attention from auditors? Why or why not?

3. Assume you are an investor in BFA. As an investor, what type of information would you be interested in reviewing before making an investment in BFA? Do you believe that BFA should have been exempt from Arizona banking laws? Why or why not?

4. Please consider the planning phase for the audit of BFA’s trust department operations. As an auditor, what type of evidence would you want to collect and examine in order to determine whether BFA was meeting the U.S. Treasury regulations for nonbank passive trustees of IRA accounts?

5. Please consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Define what is meant by control environment. Based on the information provided in the case, why does the control environment have a
“pervasive” effect on the reliability of financial reporting at an audit client like BFA?

6. Consult Paragraphs #55–59 of PCAOB Auditing Standard No. 2 and Section 301 of SOX. What is the role of the audit committee in the financial reporting process? Can you provide an example of how the Audit Committee may have been helpful in the BFA situation?

7. What is meant by the term “whistleblower” within the context of the financial reporting process? Do you think that all whistleblower complaints should go directly to the Audit Committee? Why? Do you think that a whistleblower program would have been helpful at BFA? Why?

8. Do you believe the Arthur Andersen auditors responded appropriately to the information received from BFA’s former accountant, Karen Paetz? Do you believe any circumstances exist where an auditor should ignore information from a whistleblower?

9. Please consult Section 401 of SOX. How would Section 401 apply on the BFA audit? Do you believe that Section 401 should apply to an organization like BFA? That is, do you think the section would have improved the presentation of BFA’s financial statements?

10. Please consider the sale of the Santa Fe Trails Ranch II stock by Foundation Investments to Mr. Friend. Do you believe that the auditor should have completed any additional testing beyond vouching the payment received from Friend? Provide the rationale for your decision.

11. Assuming that you would complete additional testing on the transaction described in Question 1, what is the most relevant financial statement assertion related to the transaction? Which audit procedures would you recommend to test the assertion? Why?

12. Please consult the key provisions of SFAS #66. Why did The Foundation Company’s sale of the joint venture interests in real estate developments to Dwain Hoover fail to meet the provisions of SFAS #66? In your answer, make certain to note the impact of related party activity on your conclusion.

13. If you were the lead engagement partner at BFA, how would you have responded to the refusal of CFO Estes to sign the management representation letter? Why?

14. Since there is inherently greater risk that related party transactions occur on a basis other than “arm’s length,” what steps must a company take to properly disclose its related parties?

15. Please define what is meant by “arm’s length” basis. Next, explain why gains recorded on transactions with related parties would have greater inherent risk of being overstated.
16. Please consult Paragraphs #49 and 114 of the PCAOB Auditing Standard No. 2. Define what is meant by control environment. Next, comment about the impact that BFA’s related party disclosure practices would have on an auditor’s assessment of BFA’s control environment.

17. Consult Paragraph #60 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. What is the most relevant financial statement assertion(s) about the related party transaction activity at BFA? Why?

18. Please consult Paragraph #84 of PCAOB Auditing Standard No. 2. The paragraph states that “the auditor should clearly link individual controls with the significant accounts and assertions to which they relate.” For the assertion identified in Question #4, identify a specific internal control activity that would help to prevent or detect a misstatement or lack of proper disclosure for BFA.
Case A.7

The Fund of Funds

As total assets reached $617 million in 1967, The Fund of Funds (FOF) was the most successful of the mutual funds offered by the Investor Overseas Services, Limited. In the late 1960s, FOF diversified into natural-resource asset investments. To do so, it formed a relationship with John King, a Denver oil, gas, and mineral investor and developer, whereby FOF would purchase oil and gas properties directly from his company, King Resources. By the 1970s, FOF was forced into bankruptcy.

It was later uncovered that King Resources had dramatically overcharged FOF for the properties that it sold to FOF. FOF’s bankruptcy trustee sued FOF’s independent auditor Arthur Andersen for failing to inform FOF that they were being defrauded by King Resources. As a result, Arthur Andersen was ultimately found liable and forced to pay around $70 million in civil damages, while John King was charged and convicted for masterminding the fraud against FOF.

Background

The Investors Overseas Services, Limited (IOS) was a Canadian company headquartered in Switzerland that offered diversified financial services, which included the management of mutual funds. IOS was founded in 1956 by Bernie Cornfield, a former Philadelphia social worker. One of IOS’s most successful mutual funds was its Fund of Funds (FOF). The FOF was also a Canadian company that had operations directed from Switzerland; however, its corporate records were maintained in Ferney-Voltaire, France. FOF’s total assets reached $617 million by the end of 1967.536

FOF incorporated FOF Proprietary Funds, Ltd. (FOF Prop) as an umbrella for specialized investment accounts that were managed by investment advisors. FOF Prop’s investments were heavily concentrated in American securities. Each investment advisor had a duty to act in FOF’s best interests and to avoid a conflict of interest. In

In addition, each was compensated based on the realized and unrealized (paper) appreciation of their portfolios.\textsuperscript{537}

**Challenges Faced by IOS and Its Affiliates**

During the mid- to late 1960s, IOS and its affiliates began to face several difficult conditions. The industry had become increasingly competitive as new competitors entered the field. In addition, the entire industry was negatively impacted by a decline in stock market prices. The industry was also impacted by significant regulatory changes; that is, a number of national authorities had put more regulatory controls on fund selling.\textsuperscript{538}

In 1966, the SEC brought charges that IOS had violated U.S. law by selling unregistered securities. As part of its settlement with the SEC, IOS and its affiliates, agreed to the following restrictions:\textsuperscript{539}

\begin{itemize}
  \item Will not engage in any activities subject to SEC jurisdiction.
  \item Will cease substantially all sales of securities to U.S. citizens or nationals, wherever located.
  \item Will not buy more than 3 percent of the stock of any registered investment company.
  \item Will dispose of its interests in Investors Planning Corp. of America, a registered broker-dealer, and Investors Continental Services, Ltd., a wholly owned Investors Overseas subsidiary and also a registered broker-dealer.
  \item Will withdraw the SEC broker-dealer registration of five investment companies owned by FOF.
  \item Will not acquire a controlling interest in any financial organization doing business in the U.S.
\end{itemize}


FOF Expands into Natural Resource Assets\textsuperscript{540}

FOF’s strategy for dealing with the SEC’s sanctions and the prospect of a potential stock market downturn in the late 1960s was to diversify its holdings into assets less affected by the stock market, such as natural resource assets. To set up an investment account that specialized in natural resource assets, the officers of FOF contacted John King, a Denver oil, gas, and mineral investor and developer. In February 1968, a formal contract designating a subsidiary of King’s company, King Resources Corporation (KRC), as an investment advisor to FOF Prop was circulated between Edward Cowett, the chief operating officer (COO) of FOF, and Timothy Lowry, counsel for KRC. The agreement was not finalized and, ultimately, no written investment advisory agreement was ever entered into by the parties.

However, in a presentation at a meeting of the FOF Board of Directors in Acapulco, Mexico, on April 5, 1968, Mr. King suggested to the Board of FOF that they establish a proprietary account with an initial allocation of $10 million that should be invested in a minimum of 40 natural resource properties. In the presentation, King described the role of KRC as follows: “that of a vendor of properties to the proprietary account, with such properties to be sold on an arms-length basis at prices no less favorable to the proprietary account than the prices charged by KRC to its 200-odd industrial and other purchasers.” The Board approved the idea, and the National Resources Fund Account (NRFA) was established.

The clear intent of FOF was to use King’s expertise, as it did that of other account advisors, to locate and purchase speculative investments in oil, gas, and mineral assets. FOF had no means of valuing the assets proposed for investment and no means of participating in any work requirements. FOF’s dependence was encouraged by King in two ways: King’s own corporate documents represented that KRC was an investment advisor to FOF, and its prospect summaries barely outlined the geologic and financial information that would be necessary for an informed, independent investment decision.

Yet, investments in natural resource interests were different from other FOF Prop investments in one important aspect: the interest purchased in every natural resource transaction was a portion of an interest that was owned or had previously been owned by a member of the King group.

**KRC’s Pricing Policy**

As FOF’s COO, Cowett’s general understanding of the pricing policy was stated in a memorandum written on April 19, 1968. KRC would offer properties to FOF “from time to time and on a more or less continuous basis,” the terms of sale are to be “no less favorable than those offered by [KRC] to other non-affiliated purchasers [and] all transactions will be arms-length in nature.” Cowett also stated his understanding of the relationship and pricing policy in a letter dated November 11, 1970.\(^{541}\)

**Revaluations**

FOF was required to value its investment portfolio on a daily basis because the company redeemed shares on the basis of its daily share value. The daily share value was determined by dividing the net asset value of FOF’s entire portfolio by the number of outstanding shares. FOF relied on the advice of KRC for the revaluations of its natural resource assets contained in the NRFA. Because of its speculative nature and the lack of an active trading market, determining the value of natural resource interests was very difficult.\(^{541a}\)

**Fox-Raff**

In late 1968, KRC’s founder and owner John King arranged a deal with Robert Raff, president of a Seattle brokerage firm, whereby Raff would purchase 10 percent of a specific natural resource interest that was owned by FOF. The sale was designed to provide a basis for the revaluation of FOF’s remaining 90 percent interest in the natural resource interest. The purchase price for Raff’s 10 percent interest totaled $440,000, with an $88,000 down payment.


required. The transaction provided a basis for FOF to write-up the valuation of its 90 percent interest in the specific natural resource interest by $820,000.

To execute the deal, King actually advanced Raff all of the money that was needed to make the down payment, and assured Raff that no further financial commitment was necessary. Raff intended to sell the investment within six months, so that he would never have to meet the remaining financial obligations to FOF. When FOF pressed for payment, KRC provided Raff with the means to pay.

Independent auditor Arthur Andersen questioned whether the 10 percent sale was sufficient enough to establish the value of the whole parcel. They also questioned the basis for the write-up due to the short holding period for the interest, as well as the lack of any oil strikes or any new geological information that would justify the revaluation of the parcel. Arthur Andersen resolved to express these concerns in a letter to the Board of Directors of FOF, but, ultimately, never sent such a letter. The Arthur Andersen partner working on the year-end 1968 FOF audit, John Robinson, told Edward Cowett, the COO of FOF, that Andersen could accept the Fox-Raff transaction as a basis for revaluation only because it was immaterial to the financial statements as a whole.

**Development of Guidelines for Revaluation**

In the fall of 1969, independent auditor Andersen sought to help FOF establish guidelines for unrealized appreciation or revaluations to allow for “substantive independent evidence for reviewing the reasonableness of the client’s valuations.” A November 7, 1969, memorandum set out Arthur Andersen’s proposal:

*Any significant increase in the value of natural resource properties over original cost to FOF must, for audit purposes, be supported by either:

1. An appraisal report rendered by a competent, independent expert, or
2. An arms-length [sic] sale of a sufficiently large enough portion of a property to establish a proportionate value for the portion retained …*

On the question of what constitutes adequate sales data for valuation purposes (i.e., the 10% question),

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we have proposed the following to King Resources Company:

1. No unrealized appreciation would be allowed on sales of relatively small percentages of properties to private investors or others who do not have the necessary expertise to determine a realistic fair market value. By “relatively small,” we envision approximately 50% as being a minimum level in this type of sale to establish proportionate values for the remaining interests. This would preclude any unrealized appreciation on sales such as the December, 1968, sales to Fox-Roff, [sic] Inc. since it could not be reasonably sustained that a brokerage firm has the expertise necessary to evaluate primarily undeveloped resource interests.

2. Appreciation would be allowed if supported by arms-length [sic] sales to knowledgeable outside parties. For example, if King Resources Company sold a 25% interest in the Arctic permits to Texaco or another major oil company, we believe it would be appropriate to ascribe proportionate value to the 75% retained. Just where to draw the line on the percentage has not been clearly established. We feel 10% would be a bare minimum and would like to see a higher number….

The senior Andersen partner responsible for audit practices, John March, suggested a sale of a “25–30 percent minimum,” as a more conservative figure, and stated that it “must be a cash deal with no take-out option.” Yet, the guideline finally adopted by FOF for inclusion in the 1969 Annual Report did not specify a fixed percentage that must be sold and also did not refer to the identity or attributes of a buyer. (See Exhibit 3.5.1 in Section 3, on page 85.)

**Arctic Revaluation**

In late 1969, King arranged for a sale of 9.375 percent of his group’s Arctic interest to John Mecom and Consolidated Oil & Gas (COG) to justify a revaluation for FOF. Essentially, this sale was the basis for a $119 million increase in the valuation of the FOF’s interest in the Arctic interest. Details of the transaction were provided in the 1970 FOF Annual Report. (See Exhibit 3.5.2 on page 86.)

John Mecom, who also owned U.S. Oil of Louisiana, Inc., which had lost $11,458,000 for the year ending

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September 30, 1969, faced debts of over $132,000,000 at this time. As a result of Mecom’s overall cash problems at that time, King agreed to provide the entire $266,000 down payment for the Arctic transaction, with the subsequent $10 million in payments being provided by KRC’s projected usage of Mecom’s oil and drilling equipment. Exhibit 3.5.3, on page 87, shows the written side agreement which enabled Mecom to make the Arctic purchase. Interestingly, Arthur Andersen also audited Mecom from its Houston office and, therefore, knew of his financial difficulties.544

In addition, COG was a Denver-based oil and gas concern headed by John King’s personal friend. King Resources had joined together with COG in several previous business transactions, a fact that Arthur Andersen was well aware of. To facilitate the Arctic transaction, King arranged for COG to get a $600,000 loan from a Tulsa, Oklahoma bank, without which COG would not have entered into the Arctic transaction.

Andersen obtained representation letters from KRC that the Arctic sale was bona fide. Although Andersen obtained representation letters from Mecom and COG confirming the terms of the Arctic purchase agreement, no inquiry was made of Mecom or COG as to the existence of possible side agreements. Andersen also obtained a Dun & Bradstreet report on Mecom, which likely would have showed his cash flow problems. In May 1970, prior to issuing FOF’s report, Andersen learned of a Wall Street Journal article that cast doubt on COG’s obligation related to the sale. Andersen obtained a reconfirmation from KRC, discussed the matter with COG’s principal, and obtained a reconfirmation specifically excluding side deals, but no further inquiry about side deals was made to Mecom. In late May 1970, Andersen decided that a “subject to” qualification was necessary in issuing its report concerning FOF as of year-end 1969. (See Exhibit 3.5.4 in Section 3, on page 88.)

544 In February 1968, Leonard Spacek, Andersen’s managing partner, met with King and Mecom to discuss integration of the King and Mecom organizations. Spacek also discussed a role for KRC in refinancing Mecom’s debts in May 1968 and, in December 1968, Spacek discussed the possibility of a King-Mecom joint venture with the Houston office of AA.
Andersen’s Relationships with FOF and KRC

Both KRC and FOF, including its NRFA, were audited by Arthur Andersen. Andersen also audited John King’s personal accounts. The Partner-in-Charge and the manager of the KRC audit held the same respective positions on the NRFA audit, and other Andersen staffers sometimes worked contemporaneously on the KRC and the NRFA audits. Andersen used records from KRC to perform many aspects of its audit of NRFA. Andersen’s auditors possessed minutes of an FOF Board of Directors’ meeting describing the NRFA as “essentially a discretionary account managed by King Resources Corporation.” Andersen’s auditors themselves noted KRC’s “carte blanche authority to buy oil and gas properties for [NRC]” and its “quasi-fiduciary” duty to FOF.

Prior to the year-end 1968 KRC audit, and as early as 1966, Andersen viewed John King and his companies as a difficult client, one that posed risks to Andersen itself. In fact, Andersen personnel had repeated, serious difficulties with John King as a client at least since 1961. For example, Mr. King often spoke directly with the highest echelon of the Andersen partnership in Chicago when he was displeased with the Denver office’s resolution of certain issues. Andersen also viewed FOF as presenting its own set of problems and risks.

In addition to performing substantial work on the audit of NRFA for FOF, Andersen’s Denver office had primary responsibility for the KRC audits. Therefore, Andersen’s Denver office was aware of the advisory relationship between KRC and FOF because the relationship was described in KRC filings with the SEC. The Denver office was also well aware of the lack of a written contract evidencing the terms of the relationship between KRC and FOF. In addition, it sought confirmation of the nature of any KRC-FOF agreement from KRC for a KRC audit, although it surprisingly did not seek any such information from FOF with respect to the NRFA audit.

As part of its primary responsibility for audits of the NRFA occurring after year end 1968, the Denver office of Andersen determined the cost value of NRFA purchases by using the books of KRC. Andersen only reviewed the valuations set by KRC to assess whether they were presented in accordance with FOF’s guidelines. Surprisingly, it did not determine the market value of the NRFA interests as part of the FOF audit scope.

**FOF’s Natural Interest Purchases**

Beginning immediately after the Board of Directors’ meeting where NRFA was established, on April 5, 1968, it began to purchase oil, gas, and mineral interests from KRC. King reported to the FOF Board of Directors on August 2, 1968, that $3 million of the initial authorization of $10 million was committed. For the year-end 1968 audit of FOF, the Denver office of Andersen prepared a series of comparisons of prices charged by the King group to FOF, other King affiliates, and other knowledgeable industry purchasers. The “Summary of 1968 Sales” shows the following with respect to sales to the King affiliates:

<table>
<thead>
<tr>
<th></th>
<th>Current Sales</th>
<th>Current Cost [to KRC]</th>
<th>Current Profit</th>
<th>Profit as a % of Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales to IAMC</td>
<td>$9,876,271</td>
<td>$8,220,324</td>
<td>$1,655,947</td>
<td>16.8%</td>
</tr>
<tr>
<td>Sales to Royal</td>
<td>$6,566,491</td>
<td>$4,085,544</td>
<td>$2,480,947</td>
<td>37.8%</td>
</tr>
<tr>
<td>Sales to IOS</td>
<td>$11,325,386</td>
<td>$4,307,583</td>
<td>$7,017,803</td>
<td>62.0%</td>
</tr>
</tbody>
</table>

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In the same document, Andersen’s auditors also computed the comparative profits for KRC, excluding interests sold to Royal and to IOS (which was essentially FOF). After subtracting those sales with higher markups, KRC’s profits as percentages of sales on its sales to its affiliates, Royal and IAMC, were substantially smaller than the profits on its sales to FOF.

In fact, KRC’s “Consolidated Sales to Industry,” dated September 30, 1969, illustrated that KRC’s profits on sales to FOF were 68.2 percent, as compared with average profits on all sales of nearly 36 percent. In comparing only the seven industry customers that purchased over $1 million of interests from KRC, FOF had the highest profit/sales ratio, at 68.2 percent. After FOF, the next highest profit/sales ratio, earned by KRC on sales to such customers, was 24.4 percent; the lowest profit/sales ratio was 5 percent.

**Andersen’s Knowledge of the Purchases**

By Andersen’s account, “the earliest date when anyone employed by Andersen would have become aware of KRC’s 1968 sales to FOF was in early 1969.” At the same time, evidence exists that some FOF-KRC transactions were reviewed for the 1968 year-end audit in Andersen’s Denver office before January 28, 1969. Andersen auditors from its Denver office also testified that they did some “information gathering” on the NRFA for the FOF Prop audit as of December 31, 1968. They also testified that they obtained documents related to the FOF audit from KRC. Andersen’s auditors contend that their duty of confidentiality to KRC would prohibit it from having disclosed to FOF any relevant knowledge it may have had related to KRC’s costs.

**Comprehensive List of Questions**

1. What is auditor independence and what is its significance to the audit profession? What is the difference between independence in appearance and independence in fact?

2. Consider that both KRC and FOF, including its NRFA, were audited by Arthur Andersen. In addition, Arthur

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Andersen audited King’s personal accounts. Do you believe these relationships impair the independence of Arthur Andersen? Why or why not?

3. Would your answer be any different if the fact pattern changed so that different partners were assigned to both the KRC audit and the NRFA audit? Please assume that both audit teams were completely different. If so, why would your answer be different?

4. Consult Paragraphs #32–35 of PCAOB Auditing Standard No. 2. Based on the case information, do you believe that Arthur Andersen violated any of the four basic principles of auditor independence described? Why or why not?

5. Refer to Sections 201, 203, and 206 of SOX. Based on your understanding of the FOF audit, do you believe these sections were needed? Why or why not? Be specific.

6. Based on your understanding of inherent risk assessment, identify three specific factors about IOS and/or FOF that would be likely to impact your audit procedures if you were conducting an audit of IOS and/or FOF.

7. Consider the charges brought against IOS/FOF in 1966 that ultimately led to a settlement with the SEC. As part of its standard audit procedures, do you believe that Andersen should be responsible to insure that IOS/FOF complies with the settlement? Why or why not?

8. Please define what is meant by an “arm’s length” transaction. Given that all of FOF Prop’s investments in natural resources had also been owned (or were currently owned) by a member of the King group, do you believe that inherent risk related to these transactions should be elevated? Why or why not?

9. Consider the memo illustrated in Exhibit 2.7.1. If you were auditing FOF, would this memo impact your planned audit procedures? If so, what is the financial statement assertion that would cause you the greatest concern? Why?

10. If you were auditing one of the transactions between King Resources and FOF, what type of evidence would you seek to examine to determine whether the transaction was consummated on an “arm’s length” basis?

11. Consult paragraph #7 of PCAOB Auditing Standard No. 2. Do you believe that FOF has established an effective system of internal control over financial reporting related to the valuation of its natural resource assets? Why or why not?

12. Please consider the valuation assertion related to the natural resources assets. Do you think it is reasonable for an auditor to rely on a recent sale of a 10 percent interest as evidence to justify a revaluation of FOF’s remaining
90 percent interest in the natural resource assets? Why or why not?

13. What other evidence could an auditor seek to justify the valuation of an asset where there is no active trading market for the asset? Please comment on whether Arthur Andersen’s guidelines for the appreciation of national resource properties were appropriate under the circumstances. Why or why not?

14. Based on your understanding of fraud risk assessment, what three conditions are likely to be present when a fraud occurs? Based on your understanding of the FOF audit, which of these three conditions appears to be most prevalent, and why?

15. Based on your understanding of audit evidence, did Arthur Andersen rely on competent and sufficient audit evidence in auditing the valuation assertion related to FOF’s natural resources assets? Why or why not?

16. Consider the series of comparisons prepared by the Denver office of Arthur Andersen of prices charged by the King group to FOF, King affiliates, and other knowledgeable industry purchasers. Can you think of any additional evidence that would have strengthened the “Summary of 1968 Sales”?

17. Please explain the primary purpose of substantive analytical procedures (i.e., the type of procedures that are completed during the testing stages of an audit). If you completed such procedures on FOF, do you think you could use KRC’s “Consolidated Sales to Industry,” which illustrated that KRC’s profits on sales to FOF were 68.2 percent, as compared to 36 percent on all other sales, to help execute the procedures? How?

18. Please consult your primary audit text. Do you believe Andersen’s contention that they had a duty of client confidentiality to KRC that would, indeed, prohibit the firm from disclosing to FOF any relevant knowledge it may have had related to KRC’s costs? Why or why not?
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