Auditor Responsibility Under the Federal Securities Laws: A Note From the WorldCom Securities Litigation

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Abstract

Auditors must follow the generally accepted auditing standards, and it is the responsibility of auditors to call attention to any discrepancies they find during an audit. This Article explores auditing standards in the context of the recent WorldCom securities litigation from the author's perspective as counsel for the lead plaintiff in the class action litigation.

Introduction

On Tuesday, April 26, 2005, before the five women and four men of the jury in *In re WorldCom, Inc. Securities Litigation*[1] were called to take their places in the jury box, the parties announced that Arthur Andersen LLP (Andersen)–the hold-out defendant in the case–and Lead Plaintiff New York State Comptroller Alan G. Hevesi, sole trustee for New York State Common Retirement Fund (Lead Plaintiff), agreed to settle the case after a grueling four and a half weeks of trial, just two days before closing arguments were scheduled. The Andersen case is the only civil trial to

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[1] 2005 WL 1394679, slip op. at *1 n.1 (S.D.N.Y. June 14, 2005).

result from WorldCom's demise.[2] At the preliminary approval hearing during the morning of April 26, the Honorable Denise L. Cote congratulated the parties on reaching the settlement and commended them for having presented a "fascinating trial."[3] As is customary for certain courts, Judge Cote called trial counsel back into her robing room for informal remarks and comments. Though robing room discussions between courts and trial counsel are rightfully shrouded with respect and mystery, it is safe to say that, at one point, Judge Cote humorously remarked: "To be honest with you, I was not really looking forward to a long accounting trial because accounting issues can be so boring. As the trial was conducted, however, it was interesting and at times, even exciting."

Judge Cote's comment drove home the fact that, although a good securities fraud case against an independent public accounting firm must be based on the principles embodied in generally accepted auditing standards (GAAS) and generally accepted accounting principles (GAAP) –all of which can be rather dry for non-accountants–the evidence of an accounting firm's liability tends to take the form of emails from engagement partners highlighting substantive audit risks;[4] letters from audit partners to company accounting personnel pledging loyalty and commitment as part of the company's team;[5] audit working papers that have been altered, covered with white-out tape, or gone missing;[6] and secret

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[2] Patrick Oster, *Andersen Is Lone Defendant, as WorldCom Fraud Jury Is Chosen*, BLOOMBERG NEWS, Mar. 28, 2005, *at* http://www.bloomberg.com (on file with author and with the *American Journal of Trial Advocacy*).

[3] Barrack, Rodos & Bacine, *Recovery for WorldCom Class Totals $6,128,056,840 –Nearly Double the Previous Record*, *at* http://www.barrack.com/pages/worldcom/index.html (last visited Aug. 12, 2005).

[4] David E. Rovella, *Andersen Feared Losing WorldCom in Sprint Merger, Witness Says*, BLOOMBERG NEWS, Apr. 6, 2005, *at* http://www.bloomberg.com (on file with author and with the *American Journal of Trial Advocacy*).

[5] David E. Rovella, *Andersen Auditor Tried to Reassure Client WorldCom (Update 1)*, BLOOMBERG NEWS, Apr. 7, 2005, *at* http://www.bloomberg.com (on file with author and with the *American Journal of Trial Advocacy*) (Andersen auditor Mark Schoppet "testified that he told finance chief Scott Sullivan that he would continue to provide 'good answers' after joining [WorldCom's] new accounting firm.").

[6] David E. Rovella, *Blacked-Out Andersen Audit Paper Warned of WorldCom's Expenses*, BLOOMBERG NEWS, Apr. 20, 2005, *at* http://www.bloomberg.com (on file with author and with the *American Journal of Trial Advocacy*); *WorldCom Was Criticized Early, Report Says*, CHICAGO TRIB., Apr. 21, 2005, at 3-2.

struggles between auditors and company personnel over access to relevant audit evidence–all of which can be rather exciting during a trial or deposition examination.[7] It is no wonder then, that the WorldCom trial against Andersen settled immediately after the jury was shown that a key working paper was substantially altered to hide Andersen's knowledge that WorldCom had improperly capitalized expenses as early as 1999, and after its audit partner admitted–on the stand–that the key document had somehow disappeared prior to trial.[8] At trial, the jury, and on summary judgment, the judge as fact-finder, determines whether facts like these can be linked to demonstrable violations of GAAS and GAAP–and ultimately violations of the federal securities laws.

As of 1999, Andersen had been the auditor for WorldCom or its predecessor companies for almost twenty years. WorldCom was the largest client of Andersen's Jackson, Mississippi office and one of the accounting firm's most significant clients. It issued unqualified–or "clean"–audit opinions for the WorldCom annual financial statements during the relevant period. Because of WorldCom's disclosure of the accounting fraud discovered in connection with the capitalization of line cost expenses, Andersen withdrew its "clean" opinion from its audit of WorldCom's 2001 financial statements, but it did not withdraw its opinions from its audits of WorldCom's 1999 or 2000 financial statements. The trial was about whether Andersen was liable under the federal securities laws in connection with its issuance of those audit opinions.

I. Standards for Auditor Liability

A. Auditing Standards

> Through financial reporting, businesses provide information that is intended to be useful to investors, creditors, and others who must make rational decisions about the company but who do not have access to the internal

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[7] For public access to Lead Plaintiff's analysis of the evidence against Andersen in connection with summary judgment proceedings, including analysis of relevant documents and testimony, see http://www.worldcomlitigation.com/courtdox/2004-09-17LPMemoinOppAAMotSJ.pdf.

[8] Rovella, *supra* note 6.

> records of the company. Because outsiders are expected to rely on financial statements, the statements are to be presented in a way that is comprehensible to an informed and careful reader. The overarching goal of financial reporting is "to provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence." In order to make accounting information useful, preparers must aim to make the information reliable, truthful, verifiable, and most importantly, understandable.[9]

Financial statements must be prepared in accordance with GAAP. It is the task of the auditor to reasonably "ensure . . . that accounts comply with sound accounting practice."[10] The accountant must "do this regardless of pressure from managers to present the company's financial status as favorably as [he or she] can."[11] In conducting an audit, an auditor must follow the GAAS standards as written by the American Institute of Certified Public Accountants (AICPA). The ten standards each fall under the following three categories: "General Standards, Standards of Field Work, and Standards of Reporting."[12] "Compliance with GAAS is mandatory."[13]

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[9] *In re* WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 478 (S.D.N.Y. 2005) (quoting Statement of Fin. Accounting Concepts No. 1 (Fin. Accounting Standards Bd. 1978)) (subsequent history omitted); *see also* Statement of Fin. Accounting Concepts No. 2 (Fin. Accounting Standards Bd. 1980).

[10] AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 228 (2d Cir.) (Jacobs, J., concurring), *on remand at* 119 F. Supp. 2d 386 (S.D.N.Y.), *complaint dismissed*, 119 F. Supp. 2d 394 (S.D.N.Y. 2000), *aff'd*, 39 Fed. Appx. 667 (2002).

[11] *Id.*

[12] *WorldCom*, 352 F. Supp. 2d at 479. With the passage of the Sarbanes-Oxley Act of 2002 and the creation of the Public Company Accounting Oversight Board (PCAOB) in 2002, Congress authorized the PCAOB to establish auditing and related professional practice standards to be used by registered public accounting firms. PCAOB Rule 3100, Compliance with Auditing and Related Professional Practice Standards, requires the auditor to comply with all applicable auditing and related professional practice standards. PCAOB Rule 3100 became effective pursuant to SEC Release No. 34-50331; File No. PCAOB-2004-06, Sept. 8, 2004; *see* CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards Nos. 1-2, §§ 150, 161.01 (Am. Inst. of Certified Pub. Accountants 2001) [hereinafter CASP].

[13] CASP, *supra* note 12, at No. 2, § 161.01.

GAAS requires that a company "reliably present" its "financial position as a whole."[14] The purpose of an audit is to ascertain how fairly "financial statements present the financial position, results of operations, and cash flows of the company in conformity with GAAP."[15] A company's financial statements will be certified as GAAP compliant when the auditor "indicates [his] belief that the financial statements taken as a whole are not materially misstated."[16] When complying with his duties, an auditor "must also employ 'professional skepticism,' through which 'the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence.'"[17] As Judge Cote put it, "GAAS compliance is imperative."[18]

The Supreme Court observed that, when an auditor certifies a corporation's financial status to the public,

> the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function . . . requires complete fidelity to the public trust. [T]he accountant's role [is that of] a disinterested analyst charged with public obligations.[19]

B. Standards Under the Securities Act of 1933

The Securities Act of 1933 governs the registration and public offering of equity and debt securities. Section 11 of the Securities Act "was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct

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[14] *WorldCom*, 352 F. Supp. 2d at 479.

[15] *Id*. at 480; CASP § 110.01.

[16] *Id*. (quoting CASP § 312.03).

[17] *Id*. (quoting CASP § 230.09).

[18] *Id*. at 481.

[19] United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984).

role in a registered offering."[20] This design reflects Congress's sense that accountants, along with underwriters and issuers, bear a "moral responsibility to the public [that] is particularly heavy."[21] Section 11 provides that any signer, director of the issuer, partner, certifying accountant, or underwriter may be liable if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[22] Section 11 is a strict liability statute.[23] Unlike other Section 11 defendants, who are liable for any and all material misstatements or omissions within a registration statement, an accountant may be liable only for those statements "which purport[] to have been prepared or certified by him."[24]

"Section 11 provides defendants other than the issuer of the security with an affirmative 'due diligence' defense."[25] An accountant may avoid liability with respect to "any part of the registration statement purporting to be made on his authority as an expert" where he can show that

> *he had, after reasonable investigation, reasonable ground to believe and did believe*, at the time such part of the registration statement became effective, *that the statements* therein *were true* and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.[26]

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[20] Herman & MacLean v. Huddleston, 459 U.S. 375, 381-82, *on remand* 705 F. 2d 775 (5th Cir. 1983). For further discussion of section 11, see *WorldCom*, 352 F. Supp. 2d at 491-94; *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 656-60 (S.D.N.Y. 2004) (subsequent history omitted); *In re* WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 431, 439 (S.D.N.Y. 2003) (subsequent history omitted); *In re* WorldCom, Inc. Sec. Litig., 219 F.R.D. 267, 288-90 (S.D.N.Y. 2003) (subsequent history omitted); *see also WorldCom*, 346 F. Supp. 2d at 662-78.

[21] Gustafson v. Alloyd Co., 513 U.S. 561, 581 (1995) (quoting H.R. REP. NO. 85, at 5 (1933)), *on remand at* 53 F. 3d 333 (7th Cir. 1995).

[22] 15 U.S.C. § 77k(a) (1998).

[23] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200 (1976).

[24] 15 U.S.C. § 77k(a)(4); *Huddleston*, 459 U.S. at 381 n.11; *WorldCom*, 352 F. Supp. 2d at 491.

[25] *WorldCom*, 352 F. Supp. 2d at 491; *WorldCom*, 346 F. Supp. 2d at 658-59, 662-63.

[26] 15 U.S.C. § 77k(b)(3)(B)(i) (emphasis added).

This defense is understood to be based on "a negligence standard."[27] In order to prove that he conducted a "reasonable investigation," an auditor must demonstrate that he conducted a "searching inquiry."[28] "Reasonable" is that which is deemed to be "required of a prudent man in the management of his own property."[29]

An accountant can claim the "due diligence" defense in lieu of any "professional obligation to act with reasonable care" *only* after complying in good faith with GAAP and GAAS.[30] Nevertheless, the court in *Monroe v. Hughes* added "[a] corollary rule, . . . that compliance with GAAP and GAAS do [sic] not immunize an accountant who consciously chooses not to disclose on a registration statement a known material fact."[31] Indeed, if after the auditing firm issues its audit opinion–but before the effective date of a registration statement–the auditing firm either learns something or should have learned something in connection with the performance of its procedures that should have caused it to inquire more persistently into its financial statement investigation, then the firm is required to take action. The auditing firm is obligated to either withhold its consent to the inclusion of its audit opinion otherwise incorporated into the registration statement or withdraw its audit opinion entirely–if it no longer has a sufficient basis to continue to have confidence in it, at least until such time as the auditing firm obtains reasonable assurance that the registration statement contains no material omission or misrepresentation. An auditor's due diligence obligations under Section 11 therefore requires a reasonable inquiry during the post audit interim period to obtain assurance that the certified audited financial statements contained in the registration statement are fairly stated in compliance with GAAP in light of facts learned subsequent to the issuance of the auditor's opinion.[32]

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[27] *Hochfelder*, 425 U.S. at 208.

[28] *WorldCom*, 346 F. Supp. 2d at 677-78.

[29] 15 U.S.C. § 77k(c).

[30] *WorldCom*, 352 F. Supp. 2d at 492; Monroe v. Hughes, 31 F.3d 772, 774 (9th Cir. 1994).

[31] *Monroe*, 31 F.3d at 774.

[32] *See* 15 U.S.C. § 77h(b) (1998); 15 U.S.C. § 77k(a)(4); 15 U.S.C. § 77k(b)(3)(B)(i); *see also* United States v. Natelli, 527 F.2d 311, 319 (2d Cir. 1975) (holding that, not only does the accountant have no "privilege of silence until the next audited annual statement, but "[t]he accountant has a duty to correct the earlier financial statement which

As Judge Cote summarized in her decision denying Andersen's summary judgment motion in the *WorldCom* case,

> an accountant has responsibility under Section 11 for the accuracy of the financial statements she certifies. An unqualified certification customarily asserts that a company's financial statements present fairly, in all material respects, the financial position of the company in conformity with GAAP. The certification applies to each material statement within the financial statements and to the financial statements taken as a whole. To qualify as a "reasonable investigation" of a company's financial statements under Section 11(b)(3)(B), and establish the affirmative defense of due diligence, the accountant must conduct a GAAS-compliant audit, or in the instance of a departure from the Statements on Auditing Standards, show an objectively reasonable basis for the departure. If in the performance of a GAAS-compliant audit the accountant uncovers a failure, or evidence of a possible failure, of the company to comply with GAAP in presenting its financial statements, then the accountant must further investigate the issue and make the appropriate disclosures.[33]

The court concluded that the Lead Plaintiff demonstrated the existence of hotly disputed issues of fact regarding Andersen's audit procedures at WorldCom and whether those procedures complied with GAAS. The claim was submitted to the jury for trial.

C. Standards Under the Securities Exchange Act of 1934

The antifraud provisions of the federal securities laws govern the exchange of securities in the market. Among Congress's objectives when

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he had audited himself and upon which he had issued his certificate, when he discovers 'that the figures in the annual report were substantially false and misleading,' and he has a chance to correct them"); *In re* WorldCom. Inc. Sec. Litig., No. 02 Civ. 3288-DLC (S.D.N.Y. Mar. 23, 2005); Ingenito v. Bermec Corp., 441 F. Supp. 525, 549-50 (S.D.N.Y. 1977) (stating that "the accountant may be held liable under Rule 10b-5 for the preparation of false or misleading financial statements which portray an inaccurate picture for the period covered by the report"); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 703 (S.D.N.Y. 1968) (asserting that an accountant must put in an "adequate" amount of time to perform his duties in conformity to the standards of his profession and not be "easily satisfied with glib answers"); Fischer v. Kletz, 266 F. Supp. 180, 189-94 (S.D.N.Y. 1967) (thoroughly but briefly employs the Securities Exchange Act).

[33] *WorldCom*, 352 F. Supp. 2d at 492-93.

passing the 1934 Act was "to insure honest securities markets and thereby promote investor confidence" after the market crash of 1929.[34] Congress sought "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."[35]

In the court's opinion deciding the motions to dismiss brought by the Andersen related defendants under Rule 12(b)(6) of the Federal Rules of Civil Procedure, Judge Cote explained that, to state a cause of action under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, a plaintiff must allege that "the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that plaintiff's reliance on defendant's action caused injury to the plaintiff."[36] Section 10(b) claims sound in fraud and must satisfy the pleading requirements codified in Rule 9(b) of the Federal Rules of Civil Procedure and the Private Securities Litigation Reform Act of 1995 (PSLRA).[37] "Any person or entity, including a[n] . . . accountant . . . who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5

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[34] United States v. O'Hagan, 521 U.S. 642, 658 (1997), *remanded to* 139 F.3d 83 (2d Cir. 1997); SEC v. Zandford, 535 U.S. 813, 819 (2002), *appeal after remand at* 114 Fed. Appx. 118 (2004). For a more lengthy discussion of the 1934 SEC Act, see generally Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[35] Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972) (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963)); *see also Zandford*, 535 U.S. at 819 (in addition to its discussion of why Congress passed the SEC Act, *Zandford* reiterates that the statute should be applied neither too restrictively nor so broadly as "to provide a broad federal remedy for all fraud") (quoting Marine Bank v. Weaver, 455 U.S 551, 556 (1982)).

[36] *In re* WorldCom. Inc. Sec. Litig., No. 02 Civ. 3288-DLC, 2003 WL 21488087, at *5 (S.D.N.Y. June 25, 2003) (quoting Ganino v. Citizens Utils. Co., 228 F.3d 154, 161 (2d Cir. 2000)); *see also* 15 U.S.C. § 78j(b) (2000) (prohibits "fraud, manipulation, or insider trading"); Lawrence v. Cohn, 325 F.3d 141, 148 (2d Cir. 2003) (extensively defines "security"); Kalnit v. Eichler, 264 F.3d 131, 138 (2d Cir. 2001) (explaining that, "under Section 10(b) and Rule 10b-5, the plaintiff must exhibit 'an intent to deceive, manipulate, or defraud' to have the "requisite state of mind or scienter") (quoting *Ganino,* 228 F.3d at 168); 17 C.F.R. § 240.10b-5 (2005) (prohibiting fraud as well as making untrue statements of or concealing material facts).

[37] *See* Hollin v. Scholastic Corp., 252 F.3d 63, 69-70 (2d Cir. 2001).

are met."[38] The plaintiff must show that the defendant actually *intended* to "deceive, manipulate, or defraud" in order to prove "scienter" under Section 10(b) and Rule 10b-5; showing that the defendant was merely negligent is not enough.[39]

Although there is a wealth of case law regarding pleading scienter, there are fewer cases describing the *level* of proof of recklessness or knowledge necessary for a favorable ruling at trial.[40] Judge Cote noted that "a quarter of a century ago, in reversing a judgment against an accountant under Section 10(b), the Court of Appeals for the Third Circuit observed that the 'core requirement' in proving an auditor's scienter [or fraudulent state of mind] is proof that the defendant 'lacked a genuine belief that the information disclosed was accurate and complete in all material respects.'"[41]

> A showing of shoddy accounting practices amounting at best to a pretended audit, or of grounds supporting a representation so flimsy as to lead to the conclusion that there was no genuine belief [in] back of it[,] have traditionally supported a finding of liability in the face of repeated assertions of good faith. In such cases, the fact finder may justifiably conclude that despite those assertions the danger of misleading was so obvious that the actor must have been aware of it.[42]

Judge Cote explained that "such proof can be and customarily is presented through circumstantial evidence."[43]

Citing to Honorable John E. Sprizzo's well-known formulation of an auditor's recklessness, Judge Cote explained that proof of scienter requires more than simply a misapplication of accounting principles. Rather, it requires a plaintiff to prove that

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[38] Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994).

[39] *WorldCom*, 2003 WL 21488087, at *6; *Kalnit*, 264 F.3d at 138.

[40] *WorldCom*, 352 F. Supp. 2d at 495-96.

[41] *Id*. at 495 (quoting McLean v. Alexander, 599 F.2d 1190, 1198 (3d Cir. 1979)).

[42] *Id*. at 496 (citations omitted).

[43] *Id*. at 495-96 (quoting *McLean*, 599 F.2d at 1198). For further explanation on how circumstantial evidence is used to find scienter, see also Ultramares Corp. v. Touche, 174 N.E. 441, 255 N.Y. 170 (1931); O'Connor v. Ludlam, 92 F.2d 50 (2d Cir.1937).

> the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.[44]

According to the Court of Appeals for the Second Circuit, an auditor acts with "scienter" when he acts "in a manner that easily could be 'foreseen to result in harm.'"[45] The auditor is thereby obligated to consider the consequences that could reasonably evolve from questionable accounting. The cases make clear that scienter is present under federal securities laws where (1) the auditor has *reason to know* that the financial statements do not conform to GAAP, (2) the auditor *informs management* of the nonconformity, but yet (3) the auditor *acquiesces* when management ignores its accounting advice and disseminates materially false and misleading financial statements.[46] The independent auditor is required to appreciate that its certification of financial statements by issuing a "clean" audit opinion might inspire increased activity among investors.[47]

Moreover, the accounting firm itself, in the form of "business entities" such as corporations or partnerships, "can be primarily liable for a violation of Section 10(b)."[48] A plaintiff can prove scienter by demonstrating that "a large entity, firm, institution, or corporation is acting in a manner that easily can be foreseen to result in harm."[49] It is a fundamental principle that "[a] corporation can only act through its employees and agents,"[50] and a plaintiff may carry her burden of showing that a corporate defendant acted with the required state of mind by introducing proof of a corporation's collective knowledge and intent. It is not necessary that

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[44] *WorldCom*, 352 F. Supp. 2d at 496 (citing SEC v. Price Waterhouse, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992)).

[45] *Id*. (quoting AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 221 (2d Cir. 2000)).

[46] *Id*.; *AUSA Life Ins. Co*., 206 F.3d at 229.

[47] *WorldCom*, 352 F. Supp. 2d at 496; *AUSA Life Ins. Co*., 206 F.3d at 221.

[48] *WorldCom*, 352 F. Supp. 2d at 496 (citing Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 101 (2d Cir. 2001)).

[49] *AUSA Life Ins. Co.*, 206 F.3d at 221.

[50] *Suez Equity Investors, L.P.*, 250 F.3d at 101.

a plaintiff prove that any one individual employee of a corporate defendant also acted with scienter. Many cases discussing securities fraud by accounting firms "concentrate on the firm's collective state of mind, not that of individual partners or employees."[51] Where a business acts through a team of professionals, the principles of "collective knowledge and intent" apply, and a "plaintiff is entitled to show reckless misconduct through a cumulative pattern of decisions and inaction by several . . . auditors that encompassed a multitude of important accounting issues."[52] Though a plaintiff may be able to show that individual auditors acted with scienter with respect to individual issues, she is also entitled to show that the independent accounting firm itself was reckless with respect to its certification of financial statements through the sum of its employees' activities and knowledge.

II. Auditors Defend Against Securities Claims Using Evidence of Concealment

Auditor defendants in federal securities litigation often adduce evidence that tends to establish that management actively concealed improper accounting practices from the engagement team conducting the audit of the company's financial statements. Such evidence may be so strong that it results in a complete dismissal of the claims alleged against the auditor.[53] "[B]ecause an independent accountant often depends on her client to provide the information base for the audit, it is almost always more difficult to establish scienter on the part of the accountant than on

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[51] *WorldCom*, 352 F. Supp. 2d at 497; *see e.g.*, Chill v. Gen. Elec. Co., 101 F.3d 263, 269-70 (2d Cir. 1996); *In re* Philip Servs. Corp. Sec. Litig., No. 98 Civ. 0835-MBM, 2004 WL 1152501, at **7-8 (S.D.N.Y. May 24, 2004); *In re* Oxford Health Plans, Inc. Sec. Litig., 51 F. Supp. 2d 290, 295 (S.D.N.Y. 1999).

[52] *WorldCom*, 352 F. Supp. 2d at 499.

[53] *See In re* Royal Ahold N.V. Sec. & ERISA Litig., 351 F. Supp. 2d 334, 385-97 (D. Md. 2004) (after a lengthy analysis of plaintiffs' Section 10(b) and Rule 10(b)(5) claims against the auditing company, Deloitte & Touche, LLP, the court ultimately held that the plaintiffs did not produce sufficient evidence to show that Deloitte acted with reckless disregard, especially when the "Deloitte defendants were purposely mislead by [company management]").

the part of her client."[54] Where an accounting fraud is accompanied by acts of thorough concealment, scienter will generally not be inferred on the part of the auditor absent other proof that she acted with the state of mind required to prove the claim.[55]

In the *WorldCom* case, there was no dispute that WorldCom management "actively concealed the line cost capitalization scheme" from its auditing team.[56]

> For instance, on August 16, 2001, Andersen advised WorldCom that it would be testing WorldCom's capital expenditure process. On August 22, one of the conspirators ordered the transfer of $544 million of line costs, which had been capitalized after the first quarter of 2001, out of the account in which [the costs] had been placed and into ten newly created fixed-asset accounts, which were classified as fiber-optic cable.[57]

In its defense, Andersen emphasized points like these to persuade the fact-finder that the WorldCom employees who participated in this scheme hid their actions not only from others at the company but from Andersen auditors as well.[58] But even with acts of concealment, the evidence of the existence of "red flags" that were ignored or disregarded by Andersen warranted submission of the case to the jury.

III. Red Flags Are Persuasive Evidence Against an Auditor

In the *WorldCom* case, the court ruled: "The Lead Plaintiff has shown that there are issues of fact as to whether the Andersen audit of WorldCom was so deeply flawed that Andersen acted with reckless disregard

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[54] *In re* Sunterra Corp. Sec. Litig., 199 F. Supp. 2d 1308, 1338 (M.D. Fla. 2002) (quoting Reiger v. Price Waterhouse Coopers LLP, 117 F. Supp. 2d 1003, 1007-08 (S.D. Cal. 2000)).

[55] *In re* Royal Ahold N.V. Sec., 351 F. Supp. 2d at 392; *see In re* Livent, Inc. Sec. Litig., 78 F. Supp. 2d 194, 217-18 (S.D.N.Y. 1999).

[56] *WorldCom*, 352 F. Supp. 2d at 477.

[57] *Id*.

[58] *Id*. at 499; *see also* Rovella, *supra* note 6 and accompanying text.

of whether WorldCom was engaged in fraudulent accounting practices and materially misstating its financial position in its annual financial statements."[59] There were just too many "red flags" that Andersen should have recognized that proved the state of mind required to establish liability under Section 10(b) of the 1934 Act.[60] The interplay between the proof at trial of a WorldCom GAAP violation and an Andersen GAAS violation tended to highlight the significance of the red flags as they related to Andersen's state of mind.[61] "[T]he Lead Plaintiff's identification of red flags allegedly ignored by Andersen helps to highlight one of many reasons why Andersen's audit may be found not to have conformed with GAAS."[62]

For example, Andersen's failure to test for "top side adjustments"–the term used to describe accounting journal entries made by senior management outside of the normal operating processes–was significant.[63]

> Andersen last checked for top-side adjustments in 1999, and found none, or at least no questionable adjustments. [There is] evidence that in the following years, Andersen simply accepted management's oral representations that no such adjustments had been made. . . . [S]uch a representation was itself a red flag since topside adjustments are not uncommon and can be made for entirely appropriate reasons. . . . Andersen never demanded or got unrestricted access to the company's entire general ledger and . . . its work papers do not reflect that it ever did the work customarily done to confirm that the financial statements could be traced to general ledger entries. Without performing this analysis, there was no assurance that the financial statements that were being certified came from the books and records that had been audited.[64]

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[59] *WorldCom*, 352 F. Supp. 2d at 497.

[60] *Id*. at 497-98; *see also In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 672-74 (S.D.N.Y. 2004) (discussing law concerning red flags).

[61] *See* Regina M. Calcaterra, *Notes From the Trial*, *at* http://www.barrack.com/pages/worldcom/index.html (last visited Aug. 16, 2005) (summarizing testimony of key witnesses at WorldCom trial).

[62] *WorldCom*, 352 F. Supp. 2d at 498.

[63] *See* Calcaterra, *supra* note 61 (summarizing testimony of Eugene Morse, Dave Stark, and Harris L. Devor).

[64] *WorldCom*, 352 F. Supp. 2d at 484.

To be sure, the evidence at trial showed that performing a general ledger analysis to audit the top side adjustments would have easily discovered improper accounting entries in the company's books. A former WorldCom internal auditor testified that it only took him a few hours to discover evidence of the improper journal entries in the general ledger system. Eugene Morse told jurors that he "quickly unearthed hundreds of millions of dollars in unexplained financial entries."[65] Morse testified, "I thought we had found the smoking gun. It became very apparent within the first couple of days that this was wholesale fraud."[66] Trial witness Dave Stark, who visited the Company's Jackson, Mississippi offices in December 2004 to investigate its fiscal 2001 year-end financial statements on behalf of Lead Plaintiff, testified that the accounting manipulations were easy to find because the entries were made after WorldCom's quarterly and annual books closed and often included "'large dollar amounts' with 'very round numbers.'" Stark then added, "'It was a very easy process.' . . . 'We were able to isolate the unusual entries very easily, very quickly.'"[67]

In the *WorldCom* case, the evidence against the company's independent accounting firm told an "overarching story."[68] Andersen touted its business audit model as one that began with the requirement that it "know the business" of the company it was auditing. The Court ruled that

> Andersen acted in willful blindness to the realities at WorldCom and in abrogation of its duty as an auditor. [Lead Plaintiff] has identified a host of audit failures, which would permit a jury to find that there was an egregious refusal to see the obvious, repeated failures to investigate the doubtful, and a pattern of acquiescence in improper accounting practices. There is no dispute that Andersen understood that its unqualified certification of the WorldCom financials would carry great weight with investors. This is sufficient to constitute proof of recklessness.[69]

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[65] David E. Rovella, *WorldCom Auditor Says He Found `Smoking Gun' Within a Few Hours*, BLOOMBERG NEWS, Apr. 5, 2005, *at* http://www.bloomberg.com (on file with author and with the *American Journal of Trial Advocacy*).

[66] *Id.*

[67] Rovella, *supra* note 5.

[68] *WorldCom*, 352 F. Supp. 2d at 499.

[69] *Id.*; *see also* Diya Gullapalli, *Arthur Andersen Suit to Proceed*, WALL ST. J., Jan. 19, 2005, at C5.

As the press reported on the evidence, Andersen's auditors knew that "if this [WorldCom] job is not maximum [risk], none are."[70]

Lead Plaintiff's accounting expert, Harris L. Devor, testified at trial that internal Andersen documents showed a number of identified risks associated with WorldCom's accounting. "They actually didn't do a bad job in identifying these risks, but in the execution of their job, they didn't do what they said they were going to do. The audit work in this area was pretty shoddy."[71] Unfortunately, Andersen failed to conduct the procedures necessary to address the risks known by the engagement team to threaten the integrity of WorldCom's financial statements. The evidence showed that Andersen's audit was an extreme departure from the due care required by GAAS.[72]

Conclusion

The Lead Plaintiff, New York State Comptroller Alan G. Hevesi, said in connection with the Andersen settlement of the WorldCom class action that "[t]here was a huge amount of damage that was done to the American economy. We are hopeful there are lessons to be learned from this litigation."[73] In a press release, Hevesi explained that the

> WorldCom litigation should help prevent any more massive scandals with the multi-billions of dollars in costs they impose on millions of Americans and on our economy. There is already evidence that underwriters are improving their diligence, accounting firms are strengthening their audits and boards of directors are empowered to ask tougher questions of management. Those protections will restore confidence in our capital markets and encourage millions of Americans to continue to invest.[74]

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[70] Rovella, *supra* note 4.

[71] David E. Rovella, *'Shoddy' Andersen WorldCom Audit Violated Rules, Witness Says*, BLOOMBERG NEWS, Apr. 12, 2005, *at* http://www.bloomberg.com (on file with author and with the *American Journal of Trial Advocacy*).

[72] *See id.*

[73] David E. Rovella, *Andersen $65 Mln WorldCom Accord Approved by Judge (Update 3)*, BLOOMBERG NEWS, Apr. 26, 2005, ¶ 4, *at* http://www.bloomberg.com (on file with author and with the *American Journal of Trial Advocacy*).

[74] Press Release, Office of the New York State Comptroller, Arthur Andersen, Final WorldCom Defendant, Settles (Apr. 26, 2005) (on file with author and with the

The press reported that the jurors who heard the evidence in the *WorldCom* trial against Andersen tended to agree. One juror who spoke to the press after the settlement said that the jurors, after spending the first week of the trial trying to understand testimony about accounting and financial matters, clearly favored the investors' case. The juror, a sixty-one-year-old Manhattan resident and nurse, said that the jurors began to side with the investors after the first week. "We thought their lawyers were putting on a better case because they had a better case to put on," the juror said.[75]

The Andersen settlement, with the defendant payouts of over $6 billion, brought to a close the largest securities fraud class action in United States history.[76]

American Journal of Trial Advocacy), *available at* http://www.barrack.com/pages/worldcom/settle_pr.html.

[75] Rovella *supra* note 73, ¶ 27.

[76] *Id*. ¶ 5.