The Risk of a High-Risk Client - Governance and audit failures on a high-risk client

Note: This case deals with SEC cases against Weatherford International PLC and Ernst & Young.

Weatherford International PLC, a public limited company, is one of the world's leading providers of equipment and services used in the drilling, evaluation, completion, production and intervention of oil and natural gas wells.

On March 1, 2011, Weatherford advised that its annual report for the year ended December 31, 2010, would not be filed because of the identification of a material weakness in internal control over financial reporting for income taxes. Weatherford acknowledged that its processes, procedures and controls related to financial reporting were not effective in ensuring that the amounts reported for current taxes payable, certain deferred tax assets and liabilities, reserves for uncertain tax positions, the current and deferred income tax expense and related footnote disclosures were accurate.

Weatherford argued that the following four factors contributed to the material weakness:

- Inadequate staffing and technical expertise within the company related to taxes;
- Ineffective review and approval practices relating to taxes;
- Inadequate processes to effectively reconcile income tax accounts; and
- Inadequate controls over the preparation of quarterly tax provisions

The Audit Committee determined on February 28, 2011, that previously issued financial statements for the years ended December 31, 2007, 2008 and 2009 and for the quarterly periods ended March 31, June 30 and September 30, 2010, should no longer be relied upon. The error resulted in the understatement of income tax expense by $100, $106, and $154 million in 2009, 2008, and 2007 when reported effective tax rates were 6.5%, 14.8%, and 23.0%, respectfully. On March 15, 2012, Weatherford reported another $256 million decrease in net income from 2007-2011 because of additional errors in its income tax accounting. On December 17, 2012, Weatherford further reduced net income from prior periods by an additional $186 million.

During the effected years, Weatherford repeatedly and publicly disclosed ETR (Effective Tax Rate) estimates. Management asserts that its ETR was one of its key competitive advantages resulting from a superior international tax avoidance structure. In reality, the structure was not the source of the low tax expense. Each year, James Hudgins, who served as Weatherford's vice president of tax, and Darryl Kitay, who was a tax manager, made unsupported post-closing adjustments, labeled as "dividend exclusion" on the consolidated tax provision that intentionally lowered Weatherford's actual ETR and tax expense. The adjustments involved different Weatherford entities within Weatherford's corporate elimination account and ranged from $286 million to $439 million. The adjustments were then taxed at 35% (i.e., the US statutory rate) which lowered the year-end provision for income taxes. Weatherford also accounted for withholding taxes on certain intercompany transactions (i.e., interest, management fees, royalties, and rent) on a cash basis rather than an accrual basis.

Ernst & Young

Ernst & Young was Weatherford's external auditor from 2001 to March 2013. During the decade before its March 2011 restatement, Weatherford's revenue increased from $1.8 billion to $10.2 billion. While Weatherford was one of the largest clients of Ernst & Young's Southwest Region, it was widely known that it was a difficult and risky client. Ernst & Young designated "close monitoring" status upon Weatherford, the highest-risk category that the firm. From at least 2004, Ernst & Young concluded that Weatherford posed a

"significant risk to the firm and that there is a significant chance the firm will suffer damage to its reputation, monetarily, or both."

Risk factors that Ernst & Young identified included:

- History of completing significant or unusual transactions shortly before or at year end/quarter end;
- Ability to book journal entries without multiple levels of review;
- Difficulties in auditing Weatherford's complex tax structure in a timely manner;
- Pressure on management to meet earnings and EPS requirements; and
- Significant pressure for "marginal GAAP."

Staffing the Weatherford audit was always an issue because of Weatherford's reputation. Senior management called Weatherford "one of the most challenging and demanding clients" and noted: "[T]he Weatherford . . . engagement has historically been difficult and hard on our people, frequently resulting in high turnover and generalized dissatisfaction within our team." "Weatherford is an offshore company with a complex tax structure, and a tax accounting process that historically had issues."

At the time, Ernst & Young had no mechanism to ensure that the highest-risk areas of its highest risk clients had a team composed of assurance and tax professionals that was properly selected, trained and supervised. Ernst & Young did not monitor partner and manager workloads based on client complexity and did not adequately screen the selection and training of tax personnel to ensure appropriate staffing on complex, difficult, or high-risk audits during the relevant period. Until 2011, Ernst & Young also failed to conduct mandatory training for tax managers and partners involving the coordination and execution of the audit of income tax accounts.

Despite the fraud, Ernst & Young failed to identify the material understatement of Weatherford's tax expense and issued unqualified opinions for 2007, 2008, and 2009. While the Weatherford audits were placed in a high-risk category, Ernst & Young's audit team failed to detect the company's fraud until it was more than four years ongoing. While the team was aware of the post-closing adjustments each year, they did not understand the basis for the dividend exclusion adjustment and relied on unsubstantiated oral representations from Weatherford. Overall, the team failed to conduct procedures necessary for obtaining sufficient evidence for Weatherford's income tax accounting.

Aftermath

As discussed above, in regard to its misstatement of income taxes, Weatherford restated its financial statements three times between 2011 and 2012. Ernst & Young's review of the audits shortly after the filing of the first restatement confirmed that the Weatherford audits suffered from a lack of appropriate supervision and review, inadequate and insufficient tax staffing, and unsatisfactory coordination between tax and assurance personnel on the engagement.

On March 7, 2013, Weatherford's audit committee decided not to reappoint Ernst & Young. On Sept. 27, 2016, the SEC charged Weatherford with a $140 million penalty to settle charges that it inflated earnings by more than $900 million using deceptive income tax accounting. On Oct. 18, 2016, the SEC charged Ernst & Young $11.8 million to settle charges related to its failed audits of Weatherford. Craig Fronckiewicz, the assurance partner, and Sarah Adams, the tax partner who was part of the audit engagement team, were suspended from appearing or practicing before the SEC as accountants.

Questions:

1. What is a professional accountant expected to do to demonstrate professionalism, and specifically professional skepticism, if they do not understand a material aspect of their audit client's disclosure?
2. What should occur to a professional accountant with reasonable professional skepticism if their audit client perennially makes large, late adjustments to their tax provisions, and fails to clarify tax structures in a timely manner? What should the auditor do in such situations?
3. Are high-risk clients worth the risk?
4. How does past history impact an audit?
5. Why would Ernst & Young highlight that coordination between tax and assurance personnel is important? Are there other instances during an audit where coordination would be beneficial?

This case has been prepared by Michael Marin.

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