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Title: WorldCom and the unethical behaviour of the management behind

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ABSTRACT:

This paper explores the financial reporting scandal of **WorldCom and the unethical behaviour of the management behind** the scandal. WorldCom, the second largest long distance telephone carrier in U.S, was filed for the largest accounting scandal in the history of U.S. These accounting irregularities have resulted in the prosecution of WorldCom's executives on security charges. This paper will point out many of WorldCom's shortcomings and unethical behaviour of the management.

INTRODUCTION:

The telecom fallout in the United States was vicious. Telecommunications topped the list of defaulted companies which included WorldCom (Figure 1), Tyco, Global Crossing, Ltd., NTL Inc, Williams Communications Group Inc, and XO Communication Group Inc. in 2002 (Figure 2). The year 2002 was a record year in liabilities of bankrupt firms. As table 1 show, there were 112 filings in total.

WorldCom is one of the U.S largest companies with over 20 million customers, thousands of corporate clients and 80,000 employees. WorldCom was incorporated on 1st October 1983, Hattiesburg, Mississippi. Financial Information for the company is given in table 2. WorldCom was founded by Bernard Ebbers, a former basketball coach. WorldCom started providing service as a long distance reseller in 1984. Bernard Ebbers was named the CEO in 1985. The company went public in August 1989. WorldCom kept on posting billion dollar profits. WorldCom acquired MCI Communication for $ 37 billion in 1997. WorldCom owned a third of the U.S data cables by 2001. WorldCom also owned Tier 1 ISP UUNET. WorldCom moved into Internet and data traffic and handled 50% of U.S Internet traffic and 50% of e-mails worldwide.Afterwards, WorldCom did business as MCI, which was listed amongst the biggest stock market stars of the past but ended as being the biggest case of accounting fraud in U.S history (estimated at $11 billion as of March 2004)[1]. WorldCom was already going through financial tumult due to hefty debt and declining rates and revenue. Growth in the telecommunications industry was slowing and the company had too much network capacity.

The firm made a series of striking revelation in early 2002 and was filed for chapter 11 bankruptcy protection on July 21st, 2002. WorldCom has admitted accounting irregularities in its financial statements, over five quarters. These accounting irregularities were discovered by the internal audit; the firm had taken line costs and wrongly booked them as capital expenditures, for the Year 2001 as well as the first quarter of 2002. The revelation led the Securities and Exchange Commission (SEC) to file civil fraud charges against WorldCom, a day later. The company has recently restated its 2000 and 2001 financial results [2]. WorldCom did not report for expenses when it incurred them, but hid the expenses by pushing them into the future, giving the camouflage of spending less and consequently making more money.

Millions of people, investors, employees and internet users were affected by the bankruptcy of WorldCom. WorldCom was trodden by its $41 billion debt load. WorldCom reported a profit of $1.4 billion for 2001 and $130 million for the first quarter of 2002. WorldCom stated that the irregularity was pulled out through the routine internal audit, which was conducted after the dismissal of the former chief executive Bernard Ebbers. WorldCom hired external auditors KMPG, which had replaced former auditor Arthur Anderson. Anderson said that their work for WorldCom complied with SEC and generally accepted accounting principles (GAAP) at all times and blamed the WorldCom's CFO, Scott Sullivan, for not notifying them about the line cost transfers.

WorldCom fired the CEO, CFO, COO, controller, general counsel, entire board of directors and accounting and finance employees. The U.S. Securities and Exchange Commission filed a lawsuit in U.S. District Court for the Southern District of New York against WorldCom, charging the company with fraud and asking a court to block the destruction of documents and the payment of extraordinary bonuses to executives [3].

LITERATURE REVIEW:

Principles in business are something that every one wants but few expect. In the past companies WorldCom has been in the glare of publicity because of unethical practices in accounting.

"The company said an internal audit had discovered that $3.3 billion in profits were improperly recorded on its books from 1999 to the first quarter of 2002. That is on top of the $3.8 billion in expenses the company said it had improperly reported as capital investments. WorldCom now says it must issue revised financial statements for 2000 and 1999 as well. The revision will reduce 2000 profits by more than $3.2 billion, but this may not be the end of accounting horrors as the company warned it may find more problems [4]."

The Special Investigative Committee of the Board of Directors of WorldCom, Inc. Submitted the report of investigation in which it was stated that:

“From 1999 until 2002, WorldCom suffered one of the largest public company accounting frauds in history. As enormous as the fraud was, it was accomplished in a relatively mundane way: more than $9 billion in false or unsupported accounting entries were made in WorldCom’s financial systems in order to achieve desired reported financial results. The fraud did not involve WorldCom’s network, its technology, or it’s engineering. Most of WorldCom’s people did not know it was occurring. Rather, the fraud occurred as a result of knowing misconduct directed by a few senior executives centred in its Clinton, Mississippi headquarters, and implemented by personnel in its financial and accounting departments in several locations. The fraud was the consequence of the way WorldCom’s Chief Executive Officer, Bernard J. Ebbers, ran the Company. Though much of this report details the implementation of the fraud by others, he was the source of the culture, as well as much of the pressure, that gave birth to this fraud. That the fraud continued as long as it did was due to a lack of courage to blow the whistle on the part of others in WorldCom’s financial and accounting departments; inadequate audits by Arthur Andersen; and a financial system whose controls were sorely deficient. The setting in which it occurred was marked by a serious corporate governance failure [5].”

“The plunge in WorldCom shares has cost Investors upwards of $175 billion —nearly three times what was lost in the implosion of Enron [6].”

“The circumstances under which WorldCom’s fraud was brought to light are dishearteningly similar to Enron’s Sherron Watkins’ tale. Like Ms. Watkins, Cynthia Cooper— WorldCom’s Vice President for Internal Auditing—also sought to expose and correct a massive accounting fraud. Her suspicions arose when a concerned official in the wireless division told her that accounting department had taken $400 million from his reserve account and used it to inflate WorldCom’s income. She first raised the issue with Arthur Andersen, WorldCom’s accounting firm. Although Andersen insisted that everything was fine, she continued to press on— notwithstanding that her boss, CFO Scott Sullivan, angrily told her to back off. [7]"

The fraud perpetrated at WorldCom did not take place at the lower levels of the organization. The upper management classified the huge amounts as capital expenditures. For Example, Line costs were not expensed as required by Generally Accepted Accounting Principles (GAAP).

The following paragraph taken from an Oct. 30th, 2002, *Wall Street Journal* article elaborates:

By 2000, WorldCom had started to rely on aggressive accounting to blur the true picture of its badly sagging business. A vicious price war in the long distance market had ravaged profit margins in the consumer and business divisions. Mr. Sullivan (WorldCom's former chief financial officer) had tried to respond by moving around reserves (for bad debt), according to his indictment. But by 2001 it wasn't enough to keep the company afloat. And so Mr. Sullivan began instructing Mr. Myers (senior vice president and controller) to take line costs, fees paid to lease portions of other companies' telephone networks, out of operating expense accounts where they belonged and tuck them into capital accounts, according to Mr. Sullivan's indictment. [8]

METHODOLOGY:

- Adopted a systematic approach.
- Surfing the internet.
- Scanning the books to get a broad idea.
- Searching different articles.
- Compiling the data.

- Organizing the information in a presentable format.
- Preparing for viva.

FINDINGS:

In this paper we studied the case of WorldCom, the number 2 long distance carrier in United States (Appendix A shows the timeline of events for the case of WorldCom). WorldCom became the largest corporate failure in U.S history when it was filed for bankruptcy in July 2002, earning the distinction as the major bankruptcy filing in U.S. history. WorldCom's revenues, expenses, property and equipment were materially misstated in 2000 and 2001.

i. WHAT WENT WRONG WITH WorldCom?

WorldCom improperly recorded $3.3 billion in profits on its books from 1999 to the first quarter of 2002. And WorldCom stated $3.8 billion in expenses as capital expenditure. WorldCom's chief executive, John Sidgmore, blamed the company's chief financial officer, Scott Sullivan, and the former controller, David Myers.

ii. THE FRAUD:

CEO of WorldCom borrowed $336 millions to cover losses on stock which was not repaid. He also secured loans from WorldCom to fund personal investments. Bernard Ebbers resigned from WorldCom. John Sidgmore was the new CEO of WorldCom.

CFO of WorldCom directed the staff to make false accounting entries and he himself made fake and misleading public statements regarding finances. He told the staff to mark the operating expenses as long term investments. He turned the huge losses into enormous profits. This inflated the company's value in its assets.

WorldCom's falsification of these expenses led to an artificial inflation of its Net Income and Earnings before Interest Depreciation and Amortization (EBIDTA). This transfer of apparent expenses into capital expenditures is absolutely fake, and not in accordance with Generally Accepted Accounting Principles (GAAP). The stock dropped from $64.50 to $.05 [9] (figure 3).

iii. HOW WAS THE FRAUD DISCOVERED:

The accounting errors were revealed during an investigation by the internal audit department at WorldCom. The information was sent to the board of directors' audit committee and to the independent auditor, KPMG, which had replaced Arthur Andersen as auditors in May 2002. After the investigation, WorldCom issued a statement announcing the accounting irregularities i.e. certain transfers from line cost expenses to capital assets, were not made in accordance with GAAP. The total amount of the transfers was $3.8 billion for the four quarters of 2001 and the first quarter of 2002.

On March 7th, 2002 Security and Exchange Commission (SEC) requested information from WorldCom. The internal audit found the undocumented $500 million in computer expenses that were recorded as assets. The internal auditor, Cindy Cooper, asked the company for the documents supporting several capital expenditures but no documents were found. The controller admits to the internal auditors that the accounting treatment was wrong.

After the fraud was discovered, WorldCom announced that it had inflated profits by $3.8 billion over the past five quarters. WorldCom since filed for bankruptcy. WorldCom's bankruptcy was largest in U.S history, even larger than the Enron's corporation [10].

iv. WHERE WERE THE AUDITORS?

Arthur Anderson was WorldCom's accountants at that time Scott Sullivan, CFO of WorldCom, blamed Arthur Anderson for not discovering the wrong doing. The accounting firm, Arthur Anderson put the blame back on Scott Suvillan for withholding the information regarding line costs.

Audit authorities said that WorldCom's fraud was so apparent that it should have been noticeable to the firm's auditors, Arthur Anderson. Evidence was produced against the firm in the court that they did not verify the WorldCom's treatment for line costs. The court said that Anderson could have exposed the fraud if it had conducted a review prior to issuing its audit opinion.

v. THE CONSEQUENCES:

After the fraud was discovered, WorldCom cut 17,000 jobs to save $1 billion. Their stocks were traded for cents. WorldCom added additional board members to serve as investigating panel to check the accounting practices.

The New York jury found Ebbers guilty on nine counts, one of conspiracy and one of securities fraud and seven of false regulatory filings. He faces an 85 years sentence.

In August 2002, Scott Sullivan, the CFO, was indicted by a jury on one count of fraud and six counts of securities fraud and fake filings involving almost $8 billion. Sullivan was sentenced for 25 years in prison.

The company emerged from chapter 11 bankruptcy in 2004 with $5.7 billion in debts and $6 billion in cash.

CONCLUSION:

Corporate greed at the executive level has destroyed hundreds of companies, drained stockholders of their investments, and left innocent employees without work. By reading the case it can be concluded that the WorldCom’s top executives were responsible for the downfall of WorldCom. Financial officers manipulated the numbers to overstate income by billions of dollars. It was due to the unethical actions of the these company officials that led WorldCom to file for the largest ever bankruptcy.

ANNEXURES:

FIGURE 1: THE RISE AND FALL OF WORLDCOM

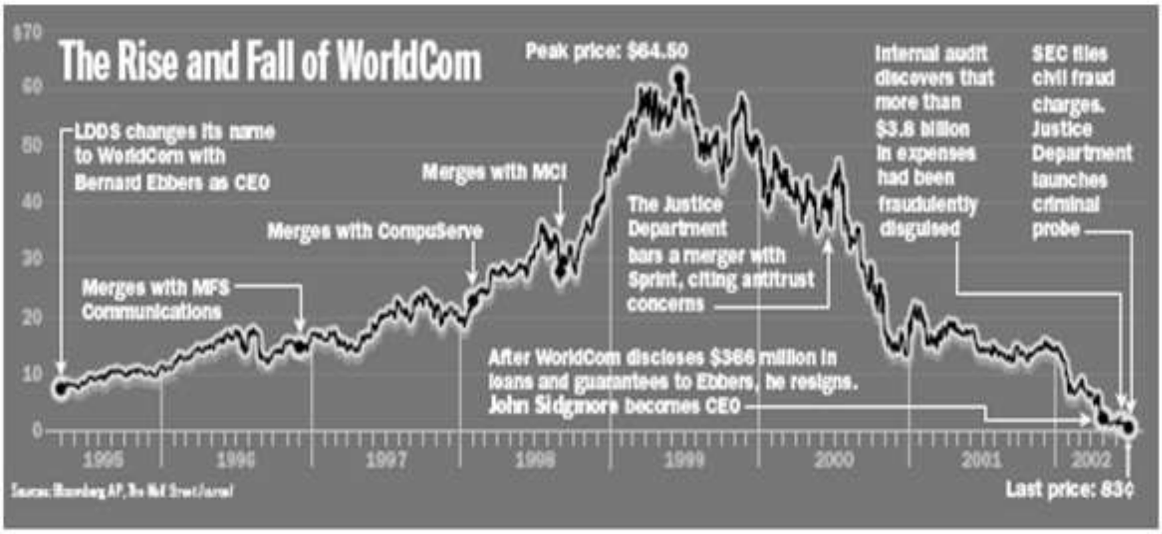

FIGURE 2: DEFAULTS IN U.S

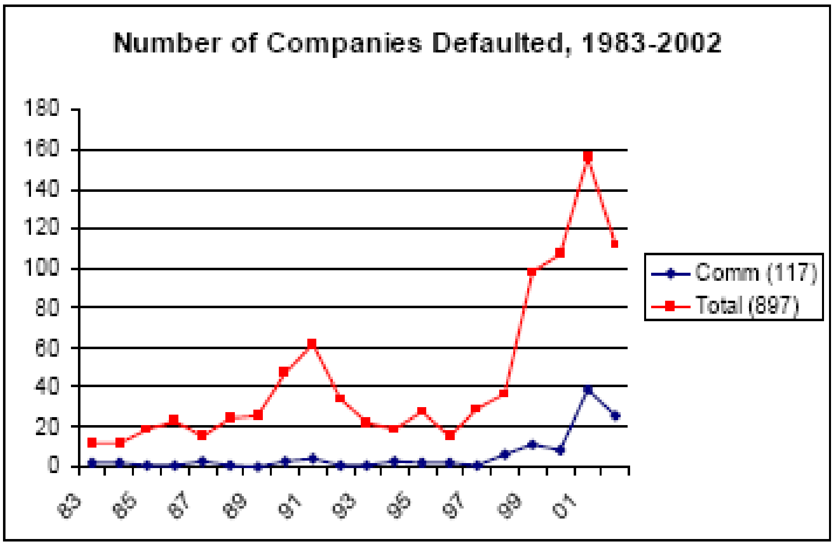

FIGURE 3: STOCK PRICES FOR WORLDCOM

TABLE 1: BANKRUPTCIES IN 2002

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	Total	Communications
No of Filings	112	31
Prepetition Liabilities	$337.5bn	$120.6bn

TABLE 2: FINANCIAL INFORMATION FOR WORLDCOM

Year	Revenue (in billions)	Net Income (in billions)

1999	$19.7	$2.6
2000	$22.8	$3.0
2001	$21.3	$1.5

Appendix: timeline of events for WorldCom

1983	Bernard J. Ebbers and partners jump into the long distance market with LDDS.
Sept. 1998	Merger with MCI. At the time, the largest merger in history.
Dec. 1998	Merger with MFS Com (Includes UUNet, Inc., the Internet backbone).
June 1999	Stock reaches its high- $96.76.
Feb. 2002	Firm cuts annual revenue and earnings projections. It is reported that CEO Bernard Ebbers owes his company $366m.
March 2002	SEC launches inquiries into accounting practices, after Enron scandal and Global Crossing's bankruptcy filing.
April 2002	Ebbers resigns as CEO of WorldCom; Sidgmore takes over.
May 2002	WorldCom becomes a "Fallen Angel"; Moody's and Fitch down-grade company's debt three notches to "junk status"; Stock drops to about $2 a share.
June 24, 2002	Analyst Jack Grubman issues a negative report about telecom's finances. WoldCom's share falls below $1.
June 25, 2002	WorldCom discloses accounting fraud; SEC files a civil suit alleging WorldCom engaged in a fraudulent scheme to pad earnings.
July 21, 2002	WorldCom files for Chapter 11 bankruptcy-court protection (largest bankruptcy in the corporate US).
Aug. 2002	Former WorldCom officials, Scott Sullivan and David Myers, are charged with fraud
Dec. 2002	Michael Capellas new chairman and CEO.
Jan. 2002	Capellas' 100 days plan.
April 14, 2003	MCI (former WorldCom) submits Plan of Reorganization and wins creditor backing; company seen emerging as early as September 2003.
June 2003	Two external investigations find that Ebbers and top managers, conspired together beginning in the late 1990s to carry out massive an systematic fraud at the company.
July 2003	MCI rivals bring a new set of fraud allegations to the attention of federal prosecutors, investigating possible "laundering" of phone calls

Aug. 2003	The Bankruptcy Court grants final approval to the company's settlement of civil fraud charges brought by the SEC. AT&T to accuse MCI of routing sensitive U.S. government calls through Canada.
Dec. 2003	John Sidgmore, who helped reveal the accounting troubles, dies at the age of 52 due to physical causes.
March 2004	Ebbers is indicted on federal charge (trial scheduled for November 2004). Scott Sullivan, who is charged with bank fraud, conspiracy and securities-fraud, and making false statement in connection with loan and credit applications, pleads guilty.

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